Tax Administration REVIEW

Inter-American Center
of Tax Administrations
CIAT

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Tax Administration
AEAT

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EDITORIAL POLICY

The Technical Cooperation Agreement signed by CIAT and the State Secretariat of Finance, 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 disseminat the different tax approaches in force in Latin America and Europe.

An Editorial Board formed by CIAT officials (the Executive Secretary, the Director of Tax Studies and Research, the Director of Training & Human Talent Development and Head of the Spanish Mission) is responsible for determining the topics and selecting the articles for each edition of the Review.

The articles are selected, through a public announcement made by the CIAT Executive Secretariat for each edition of the review. It is open to all officials of the Tax, Customs Administrations and/or Ministries of Economy and Finance of the CIAT member countries and associate member countries. Likewise, those members of the MyCiat Community not belonging to any of the aforementioned entities may also participate, following evaluation by the Editorial Council.

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Editorial

Dear Readers,

We are pleased to present to all the tax administrations officials of the members and associates member countries of our organization and, in general, to the entire international tax community, the Tax Administration Review that is published as part of the Technical Cooperation Agreement that CIAT maintains with the State Secretary of Finance, the Institute of Fiscal Studies (IEF) and the State Agency for Tax Administration (AEAT) of Spain.

This edition presents (9) articles: IFRS and taxation: challenges and opportunities for tax administrations; Dividends and profits in the Uruguayan tax system and the recent incorporation of the presumptive regime; Digital technologies in the tax industry: the case of VAT; Topics to consider for the control of the income tax in the mining sector; Criteria for the inclusion of taxpayers in a Large Taxpayers unit: a methodological guide; Forest biological assets NIC 41 and their impact on Income Tax in Ecuador; Segmentation of taxpayers as a balancing strategy of the administrative burden in the compliance with transfer pricing documentation obligations; The Macroeconomic Convergence at SADC: What are the challenges posed within the framework of Intraregional Trade? and Prospective in the tax administration collection strategy.

We appreciate the great reception given to the call to submit contributions for this edition of the Tax Administration Review.

We reaffirm our commitment to disseminate information of interest that contributes to learning and stimulates the transfer of useful knowledge for the international tax community.

Márcio Ferreira Verdi
Director of the Review

IFRS AND TAXATION:

CHALLENGES AND OPPORTUNITIES

FOR TAX ADMINISTRATIONS

Luis A. **CHÁVEZ**

SYNOPSIS

Through the adoption of the International Financial Reporting Standards (IFRS), the measurement of various accounting elements has changed significantly, affecting the taxes based on accounting. This make indispensable the adjustment of tax regulations to provide tax certainty. This document reflects the author's experience working as an IFRS consultant for tax administrations, private companies the SMEIG (Advisory group of the International Accounting Standards Board –IASB). In a friendly format, a clear language and with several illustrative examples, this work provides a framework for the tax administrations to address successfully the challenges and opportunities of this paradigm change.

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1. The International Financial Reporting Standards
2. The tax systems and their regulations
3. IFRS and tax regulations: main differences
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6. Changing paradigm: Deferred taxes reconciling differences
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THE AUTHOR

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INTRODUCTION

For more than 30 years, the financial statements of most companies in Latin America were prepared using the fiscal rules of each country, and not necessarily financial principles. This distortion consists in *"converting"* financial accounting into tax information, which has created a "hybrid" that is neither properly "financial information", nor is it properly "tax information", confusing the real objective of the financial statements: to reflect a true image of the transactions for the adequate economic decision making on the resources supply of a company.

With the application of IFRS in Latin America, a greater emphasis is being given to the financial principles for the preparation of financial statements, and consequently, a trend has taken place to *"emancipate"* financial accounting from tax information (i.e. stop applying the tax rules for the preparation of the financial statements.

In his professional practice, through consultancies and trainings to various private companies in their processes of implementation of IFRS during the last years, the author has noted that business leaders and investors, in the first instance, recognize the benefits of these international norms that aim to reflect the economic reality of the company for a better decision making. However, it has been verified that the uncertainty about tax treatments for new types of income and expenses, among others, implied by the implementation of IFRS is a great constraint, by which many companies do not achieve a full application of these standards. This happen when a country's tax regulations are not yet properly reformed to consider all these accounting changes – since the corporate income tax takes as a starting point what is reported in the financial statements.

Therefore, if the preparation and presentation of such financial statements evolves (by the application of IFRS), it is imperative that a country's tax regulations also evolve to consider all new cases and provide tax certainty to companies and investors, of course, always safeguarding the fundamental principles of taxation, such as: "contributory capacity" and "neutrality".

In this way, the companies will be able to apply without reserve the full IFRS, appreciating then their economic reality for a better decision making and obtaining greater access to loans and credits through high quality financial information. In parallel, companies will also be able to comply properly with the country's tax regulations (since if reformed, they would provide the appropriate clarifications in the tax treatment of the new types of accounting records).

When this will be considered, the tax administrations, investors and entrepreneurs will have more certainty about the tax effects of the application of the IFRS, promoting local and foreign investment, and improving the tax competitiveness of a country in the Latin American region. This economic context will also promote, of course, an increase in tax collection.

We will then move on to address specifically what IFRSs and their objectives are, to specify the objectives of the tax systems and their regulations. First, we will develop each type of regulation separately (financial and tax aspects), and then contrast them and analyze their differences with the objective of providing a framework of reference to the tax administrations in their processes of analysis of tax effects of the IFRS application in the financial statements of taxpayers.

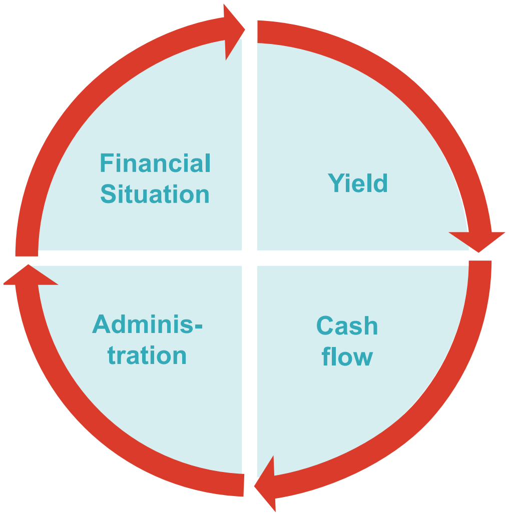
1. INTERNATIONAL FINANCIAL REPORTING STANDARDS

The International Financial Reporting Standards (IFRS, or also known as IFRS) are a set of principles or standards for the preparation of financial statements for general information purposes. IFRSs are issued by the International Accounting Standards Board (IASB), a London-based agency.

1.1 Objective of the "financial statements for general information purposes"

This product obtained by the application of IFRS (which sometimes in practice, we shortened as *"financial statements"*) aims to provide information of the entity on the following aspects shown in Figure 1:

Figure 1: Information provided in the financial statements



The purpose of the financial statements is to satisfy the information needs of investors, lenders and other existing and potential stakeholders to make decisions about the supply (or not) of economic resources to the entity. That is to say, the financial statements that are prepared under IFRS are destined, in fact, to capital suppliers, mainly for financial decisions (hence their name: *financial* statements).

Therefore, the information prepared and presented under IFRS seek to be transparent and timely, showing a true image of economic transactions. It is directed to those who have placed their economic resources in the company (some shareholder, or some buyer of bonds or obligations issued by the company, for example), or for a potential capital supplier (foreign investor who is interested in investing in our company, or a bank where we wish to apply for a loan, among others). Therefore, IFRSs correspond to a global financial language between the reporting companies and the various capital providers (in other words, they become a communication code between "borrowers" and "suppliers" of capital.

In short, a company that does not fully apply IFRS will not be able to reflect its true economic situation and performance, and will be at a competitive disadvantage to obtain capital if they do not provide transparent and high-quality financial information.

1.2 Basic Principles in IFRS

Among the basic principles included in IFRS for the preparation of the financial statements, the following are highlighted:

Accrual: Also known as accumulation base. According to this principle, the effects of transactions and other facts are recorded in accounting when they occur, not necessarily when money is received or paid. The financial statements, prepared on an accrual basis, inform users not only of past transactions represented by cash receipts or payments, but also of future payment obligations and of the resources that represent cash receivable in the future. Therefore, such statements provide the type of information about transactions and other past events that are more useful to take economic decisions.

Going concern: The financial statements are normally prepared based on a company that is in operation, and will continue its operation activities in the foreseen future. It is therefore assumed that the company has neither the intention nor the necessity to end or significantly decrease the level of its operations. The going concern principle constitutes the fundamental postulate of the financial information prepared under IFRS. If the reporting entity does not comply with the going concern principle, the financial statements should be prepared on a different basis and, if so, the basis used will be disclosed.

1.3 Convergence process in Latin America

The process of global convergence towards these standards generates new challenges and opportunities for all types of entities that implement this international regulation, and of course, the control bodies of these entities. According to the International Accounting Standards Board (IASB), the agency that has issued IFRS, currently more than 130 countries require or allow the application of the Full IFRS for the elaboration and presentation of corporate financial statements; and more than 80 countries have adopted IFRS for SMEs. This process of harmonization of financial information has definitely not been alien to Latin America.

What are the Full IFRS standards and which entities should apply them?

The Full IFRS comprise a set of standards, namely:

- International Accounting Standards (IAS) and their respective interpretations (SIC).
- International Financial Reporting Standards (IFRS) and their respective interpretations (IFRIC).

The content of the Full IFRS currently exceeds 3,000 pages and are applied by companies subject to an obligation of "public accountability". An entity has a public obligation to be accountable if:

- Its debt or equity instruments are negotiated in a public market or are in the process of issuing these instruments to be negotiated in a public market (either a national or foreign stock exchange, or a market outside the stock exchange, including local or regional markets); or

- One of its main activities is to maintain assets as a fiduciary for a large group of third parties (most banks, credit unions, insurance companies, commissioners and securities intermediaries, investment funds and investment banks would comply with this second criterion..

What are IFRS for SMEs and which entities should apply them?

IFRS for SMEs is a comprehensive IFRS-based standard that must be applied in an autonomous manner. IFRS for SMEs is subdivided into 35 sections, comprising about 300 pages. Entities may apply IFRS for SMEs when:

- They have no public obligation to submit accounts; and

- They publish financial statements for the purpose of general information for external users.

Examples of external users are the owners who are not involved in the management of companies, current or potential creditors, and credit rating agencies.

2. THE TAX SYSTEMS AND THEIR NORMATIVES

The tax system in each country is formed by a set of taxes whose first goal is to meet economic objectives. For example, employment, growth and economic equilibrium. A tax system is considered as the main revenue stream that a state needs to be able to cover expenses demanded by citizens, such as education, housing, infrastructure, health, among others.

2.1 Objectives of tax systems and their regulations

The main objectives of tax systems and their regulations are to achieve economic stability, allocate resources appropriately, promote a country's economic growth, ensure employment, provide food sovereignty, and help implement a fair distribution of wealth. Currently, the taxes in each country are regulated by the respective supervisory bodies, through which, via their instruments and regulations, the taxpayers can easily comply with their tax obligations. The tax regulations correspond to a set of legal bodies that regulate the activities of the taxpayers for the fulfillment of their tax obligations. They aim enabling tax administrations to collect sufficient resources to finance investment and public spending.

2.2 Basic principles of taxation

The tax principles are the basic elements that a tax should have, among which the following are highlighted:

Legality: This principle indicates the exclusive authority of a state for a tax to be established by law, so that a levy or a tax is not applicable without a law that establishes them, i.e. there is no tax without a previous law.

Equality or equity: this principle requires equitable treatment of all taxable persons, on an equal footing, without benefits or levies in terms of race, color, sex, language, religion, political affiliation, economic position, among others. This principle must be understood as equality for taxpayers in similar conditions.

Neutrality: This principle refers to the application of taxes should not alter the economic behavior of taxpayers, that is to say, little interference of taxation in the functioning of the market.

Simplicity: According to this principle, a tax system must have a technical structure that is functional. This generates low costs of compliance by taxpayers and control by the tax administration.

2.3 The income tax

One of the main taxes in the tax regulations is the income tax (also known in some countries as tax on profits), which is applied on the income obtained by individuals or legal entities, by the application of a rate that can be fixed or progressive, and for this reason, it is considered a direct tax. In general, this tax applies to all economic activities carried out by individuals or legal entities, from which the discounts, costs and expenses attributable to such income can be deduced, in such a way that what we call *taxable base*-also known as *tax utility* (or, failing that, tax loss) may be identified -to calculate the income tax.

At the time of identifying the taxable base for the calculation of the tax, the corresponding rate is applied under the current legislation of each country, obtaining thus the value of the tax payable. This tax is usually calculated annually, as the taxpayer establishes the taxable base based on taxable revenues minus the deductible costs and expenses that have been obtained during a fiscal period.

3. IFRS AND TAX REGULATIONS: MAIN DIFFERENCES

The financial regulations and the tax regulations pursue different objectives. On the one hand, the IFRS seek to reflect the economic reality of a company to meet the information needed by its capital suppliers and, on the other hand, the tax normative seek to establish rules to safeguard the tax collection goals in order to finance the public investment and public spending.

It is important to note that in practice, IFRS are applied through principles. Because IFRSs are standards that apply to companies with different economic realities (and including in different latitudes in the world), these standards cannot be intended to reflect a true image of all companies (which have different realities and types of transactions) through fixed rules. Therefore, the IFRS consider the application of principles, requiring the use of professional judgement and the best available information, to reflect the economic reality of a company in the financial statements.

Example: estimation of the useful life and depreciation expense

An example of these principles is the estimation of the useful life of assets, facilities and equipment in a company. IFRS define the useful life as the period during which the entity is expected to use the asset. In addition, the depreciation is the systematic distribution of the depreciable value of an asset over its useful life.

Consider a company "A", which buys a vehicle and is going to use it intensively in a rural area. Using professional judgement and the best information available, a 3-year life span is estimated for the vehicle. Consequently, the depreciation expense will be calculated based on that useful life, since it will represent the true wear of the good (i.e. the economic reality of the company "A" in relation to that vehicle).

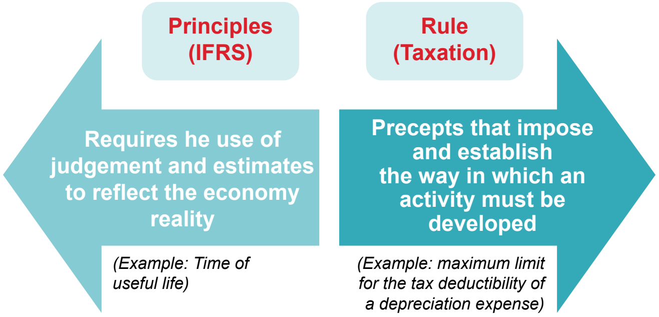
In parallel, consider another entity, the company "B", which acquires the same vehicle, for the same value and on the same date. However, this company is going to use the vehicle occasionally in an urban area. Using professional judgement and the best information available, a 7-year life span is estimated for the vehicle. The depreciation expense should therefore be calculated based on that useful life, as it will represent the true wear of that good (i.e. the economic reality of the company "B" in relation to its vehicle).

It is important to emphasize that applying the IFRS, although the companies "A" and "B" acquired the same vehicle, for the same value and on the same date, their accounting treatments are different, due to the application of principles that reflect their different economic realities. However, it is important to note that, while tax rules are also based on fundamental principles described in the previous section, they are applied in practice usually through regulations.[1]

Following the same example of companies "A" and "B", although for purposes of preparation and presentation of financial statements, a company depreciates the vehicle in 3 years and the other in 7 years. For the purposes of the income tax return, a country's tax regulations may allow, for example, an annual tax-deductible expense (for depreciation) up to 20% of the cost of the vehicle. This rule applies in general to the different taxpayers for the purposes of the income tax return, regardless the real depreciation expense recorded in their balance statement by the application of IFRS.[2]

With the foregoing, we do not want to show that a principle is superior to a rule or vice versa, but rather, that the application of principles makes possible to achieve the specific goals of IFRS; and that the application of rules, in this case the tax regulations, can also achieve their objective.

Figure 2: Differences between principles and rules


Principles (IFRS)
Rule (Taxation)
Requires he use of judgement and estimates to reflect the economy reality
Precepts that impose and establish the way in which an activity must be developed
(Example: Time of useful life)
(Example: maximum limit for the tax deductibility of a depreciation expense)

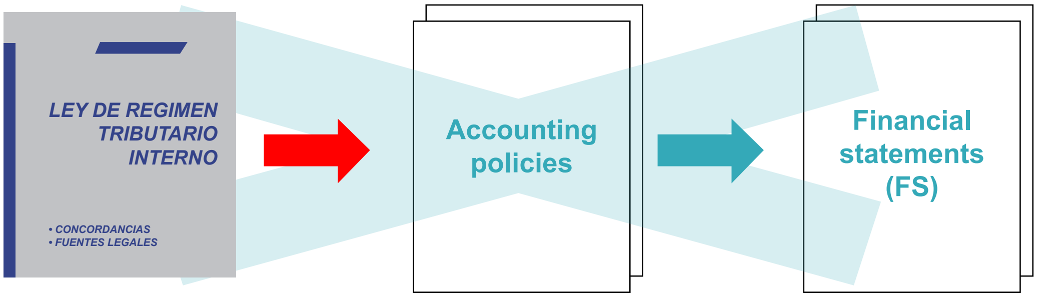
4. HISTORICAL DISTORTION IN THE PREPARATION OF FINANCIAL STATEMENTS

The objectives of the financial regulations and the tax regulations being different, unfortunately for more than 3 decades a historical distortion has been existed in the preparation and presentation of financial statements in Latin America. The tax legislation has often been considered as if it were the source or the basis for the creation of accounting policies, and with these, prepare and issue the financial statements. This conception – shown in Figure 3 – is erroneous.

[1] Just to meet the tax principle of equality or equity among taxpayers.

[2] If taxpayers had simply calculated and posted an annual depreciation expense equivalent to 20% of the cost of the vehicle relying directly on the tax regulations, that approach would have been wrong, because they would be turning into tax regulation the financial accounting (instead of applying the IFRS principles). Therefore, they would not necessarily reflect their economic realities in the financial statements.

Figure 3: Historical distortion in the preparation of financial statements in Latin America



As we have noted earlier in this work, tax regulations have not been created with the aim of providing principles or guidelines for the preparation of financial statements (but to preserve the state's tax collection). This distortion has often been referred to as *"tax regulating"* the financial accounting. This "tax-accounting" produces a hybrid, which is not fully a financial information, nor is it completely tax information; failing to reach then the real objective of the financial statements that is to reflect the economic reality of the entity for the economic decision making of the existing and potential capital suppliers.[3]

Here we highlight the main causes of this situation:

- A traditional preponderance of tax rules on financial information.
- The lack of knowledge of accounting and technical principles by the drafters of financial statements.
- Uncertainty about the tax effects of the application of IFRS. [4]
- A misinterpretation of the premise: "In the event of divergence between tax rules and accounting and financial rules, the first shall prevail.[5]"

[3] We have a traditional example of this issue when registering in accounting the expense of unrecoverable or doubtful accounts (deterioration of the value). The entities have used a percentage fixed in the tax legislation (depending on the tax regulation of each country, this percentage has corresponded to 1%, or 2%, for example), instead of conducting a credit analysis of the accounts receivable to record a deterioration according to the economic reality of the entity (as required by the IFRS). If the analysis is carried out in conformity with IFRS, there will be cases of companies in which no deterioration should be recorded (i.e., no expense for unrecoverable accounts) in the accounts receivable (because it is possible that the entity has a healthy credit portfolio and high rotation). Another classic example is provided if the depreciation expenditure of companies has been recorded in the accounting following tax guidelines (for example through a percentage or rate established in the tax regulations). This has been many times the situation of edifices in some countries, whose depreciation has been accounted at a rate of 5% per annum on the cost (which is equivalent to a life of 20 years). There, in the economic reality, most buildings have a useful life much higher than 20 years, and in accordance with IFRS, such buildings should be depreciated in accounting depending on the real time expected to provide economic benefits to the entity (therefore, the accounting depreciation rate should be lower than the one of the tax normative).

[4] By working on the implementation of IFRSs in companies, although the businessman and financial statement drafters recognize the utility of IFRS for, for example, obtaining a bank loan, many companies end up being reluctant to apply certain accounting principles due to the tax contingencies that they can cause. For example, when IFRS is implemented in an agricultural enterprise, the corresponding international standard requires that the accounting balance of the biological assets (live animals and plants used in the agricultural activity) be updated period by period to its ' Fair value less sales costs '. (This can be assimilated as adjusting the accounting balance of the biological asset periodically to a current market value). As normally the biological asset grows (biological transformation), it gains physical attributes that make it more appreciable in the market, and therefore increases its fair value. Therefore, the accounting adjustment would require increasing the balance of the biological asset and, in turn, recognizing an income for this concept in the income statement. Because of this IFRS requirement, the statement of financial position will present a biological asset to current values (i.e. market values, not merely historical costs), and in addition, the income statement will reflect a performance within the period that is the product of the agricultural activity of the entity. In this sense, the entrepreneur understands and feels comfortable to present financial statements that reflect this economic reality. As our experience has shown, by applying IFRS, some agricultural companies have gained more access to credit lines, and in other cases, their overseas suppliers have increased their credit quotas. This happens when high quality financial information performs its mission: to provide greater access to capital, through transparent, reliable and timely information (this has been achieved when the respective tax reforms have been made in the country to clarify that therefore these income, and increases in the biological assets balances are not subject of income tax). However, it happens that the tax regulations of the country do not specifically contemplate the tax treatment of such income by updating the balance of the biological asset to market values (nor the tax treatment of the increase in the asset balance -if there is some tax that is calculated according to the value of the assets). In this case, the agricultural entrepreneurs and other investors can become reluctant to apply the IFRS in the measurement of their biological assets. Because of tax uncertainties in case that these increases are recorded in the assets and the respective accounting gains. Therefore, as our experience has shown, the companies consequently ' skew ' the application of IFRS, and measure their biological assets using the historical cost (i.e., accumulating in the accounting balances historical expenses attributable to the biological asset, instead of a market valuation), losing in this way companies and investors the benefits derived from the full application of IFRSs.

[5] Unfortunately, there has been a misinterpretation or ' oversizing ' this tax regulations' premise. The scope of this premise is only the process of "tax reconciliation", that is, when the accounting utility or loss (which has been obtained product of the application of IFRS) is made in the form of over-accounting adjustments in the income tax return (conciliation items) in accordance with tax regulations to make it a taxable utility or tax loss. Therefore, the scope of this premise should not transcend the preparation and presentation phase of financial statements (where the financial regulations prevail).

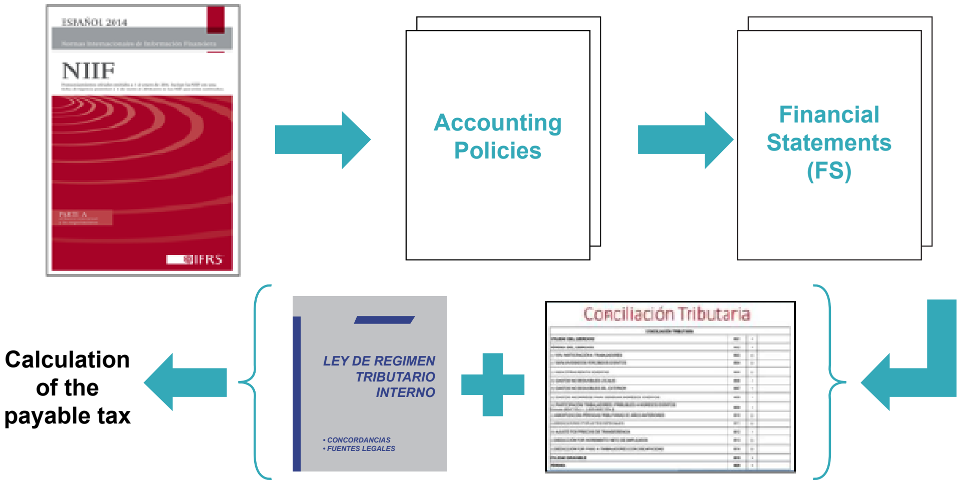
5. CORRECT APPROACH IN THE PREPARATION OF FINANCIAL STATEMENTS

A correct conception in the preparation of financial statements is to consider a financial regulation (for example, the Full IFRS or the IFRS for SMEs) as the source or basis for the creation of accounting policies in an entity. Based on such accounting policies, to issue the *financial statements for general information purposes* whose target audience corresponds to investors, lenders and other existing and potential creditors of the entity, in other words, capital suppliers. However, if in a country these financial statements are also used for other particular purposes, that is, rather, a *secondary* or *derivative* use of the financial information.[6]

For example, the central bank of a country may find useful information that companies publish in their financial statements for the elaboration of their statistics by economic sectors. Similarly, a tax administration can find useful information published in the financial statements for calculating a tax, as is the case of income tax.

If the financial statements in a country are also used as a "starting point" or "reference base" for calculating the income tax[7], then it is through the *tax conciliation* tool, where – once the accounting profit or loss is obtained with the full implementation of IFRS – additional adjustments are made to prepare the income tax return (called conciliation items). This allows converting that accounting balance into a utility or loss for tax purposes (called taxable utility or fiscal loss), and in this way, obtain the respective income tax payable.

Figure 4: Correct conception in the preparation of financial statements



"In case of divergence between the tax rules and the accounting and financial rules, the first will prevail."

Once the financial statements are prepared in accordance with IFRS, note in Figure 4 that it is via a second phase (i.e., when calculating the taxable utility or tax loss through tax conciliation) that the tax regulations of a country are rigorously applied and the corresponding tax payable is calculated.

It is during this second phase that the premise applies: ***"In case of divergence between tax rules and accounting and financial rules, the first will prevail"***, because at this stage we are no longer preparing financial statements, but calculating the basis for the calculation of a tax, where the tax regulations prevail.

[6] Which is to meet the information needs of existing and potential capital providers (investors, lenders and other creditors) of an entity.

[7] The case in Latin American countries.

Note then that IFRS and tax regulation can coexist. The roles of both regulations do not overlap; rather, they complement each other: the action of the tax rules begins once the action of the financial regulation has ended.

5.1 The tax conciliation

The tax conciliation is a complementary tool that serves to transform accounting results into tax results. In other words, tax conciliation is "extra-accounting". By using the term "extra-accounting" in this document we refer to the fact that they are adjustments (increases or decreases) made on the accounting result under IFRS. However, these adjustments are not recorded in the accounting accounts as such, but it is through a separate procedure where the accounting utility or loss is restated, to turn it into a taxable utility or tax loss. This result applies the corresponding tax rate in order to obtain a tax on the income caused.

Example: Non-deductible accounting expense for income tax purposes

For example, consider a taxpayer who has earned an accounting profit (countable income minus costs and accounting expenses) of $9,000 in his/her balance statement (product of IFRS application). Within the accounting expenses is registered a fine of $1,000 – although it is an expense for accounting purposes – is considered a non-deductible income tax expense in the tax regulations of the country.

This difference between the accounting and the tax being established, it is through the process of tax conciliation where we resolve this divergence. As this expenditure has been deducted at the time of calculating the countable income, to annul the effect we will have to "add it" in the tax conciliation, as a conciliatory entry (extra-accounting).[8] In other words, we have reinstated this cost for the fine ($1,000) to the accounting gain ($9,000), in order to obtain a taxable profit[9] ($10,000). When this taxable income is multiplied by the applicable tax rate, then the income tax caused is obtained. Figure 5 shown below summarizes the above example and the use of tax conciliation[10]:

Figure 5: Tax conciliation and income tax calculation

Countable Profit (loss)	**9.000**
Tax reconciliation	
(+) Fine	*1.000*
(=) Taxable profit (tax loss)	**10.000**
Income tax rate	*22%*
Payable tax	**2.220**

5.2. The financial statements prepared under IFRS as a "starting point" for the determination of a taxable base

Since the financial statements prepared under IFRS constitute a true image of the financial situation and the performance of a taxpayer, the accounting utility can be considered as a starting point (by adjusting this accounting utility with certain limitations and exceptions) for the determination of the taxable base for the calculation of the income tax.

However, the financial regulations and tax regulations pursue different objectives, so it is important that the tax administrations carry out a careful analysis and reform processes in their tax regulations. They must incorporate the new concepts, terminologies, and techniques from financial regulations, considering certain exceptions and limitations of these concepts and techniques, in compliance with the tax policy and ensuring compliance with the fundamentals principles of taxation, such as legality, equality, contributory capacity, neutrality and simplicity.

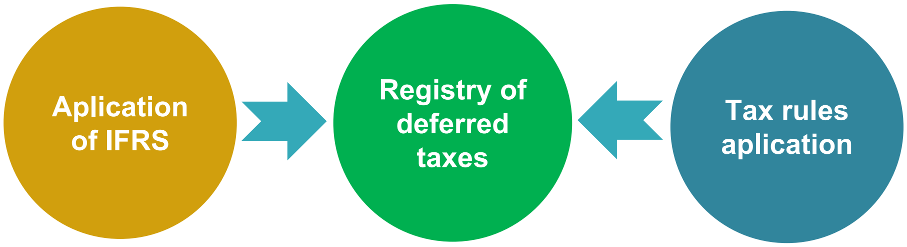
[8] On the example, let us assume that all other costs and expenses are income tax deductible, and that all income is taxed from income tax. If in another case, there have been accounting incomes that are not taxed for income tax purposes, these securities should have been ' subtracted ' in the tax conciliation.

[9] The taxable income is also referred to as '"taxable base" or "fiscal gain".

[10] An applicable 22% income tax rate has been assumed in this example.

We have previously emphasized that the means to achieve the coexistence and full application of both financial regulations and tax regulations is the tax reconciliation. In addition, it is also necessary to indicate that the so-called **"deferred taxes"** must of course be accounted for in full compliance with both regulations. In other words, at this time we will say that the accounting record of deferred taxes surges from the fulfillment of both the financial regulations and the tax regulations.

Figure 6: Deferred tax registration as product of IFRS application and simultaneous compliance with the tax regulations



Hereafter we will explain in detail this concept of "deferred taxes" that we have introduced.

6. PARADIGM CHANGE: THE DEFERRED TAXES RECONCILING THE DIFFERENCES

In accordance with IFRS, when the effects of income tax are recorded in accounting, they must reflect the *current* and *future* fiscal consequences in the financial statements. The current tax consequences are reflected when we account for the income tax payable each year (also known as "current tax"). On the other hand, the future fiscal consequences are reflected by the registration of the deferred taxes. Deferred taxes may be of two types:

- Deferred tax assets
- Deferred tax liabilities

6.1 Deferred tax assets

In general, a deferred tax asset represents a tax deduction in future fiscal years (through tax conciliation), a result of the recovery of an asset or the liquidation of a liability. [11]

To explain the functionality of the deferred tax assets, and how they allows full compliance with IFRS and tax regulations simultaneously, let us consider a practical example.

Example: loss due to inventory value impairment

As of December 31, 2018, a part of inventories with a book value of $100,000 has deteriorated. In compliance with IFRS, the taxpayer has reduced the book balance of that inventory to $70,000, recognizing a loss in the income statement by $30,000. During 2019, the taxpayer sells that inventory for $70,000.

[11] We may also consider that the deferred tax asset symbolizes a tax credit that will be recoverable (through tax reconciliation) in subsequent fiscal years.

In 2018:

In application of the IFRS (accounting technique), the taxpayer must deteriorate that inventory by a value of $30,000 in 2018, as follows:

Accounts	Debit	Credit
Impairment loss of inventory value	30.000	
Accumulated deterioration in the value of inventories		30.000

The account "loss due to deterioration of inventory value" is an expense account in the income statement; and the account "accumulated deterioration of inventory value" is a corrective asset account (valuation account). In this way, the users of the financial statements obtain reliable and timely information, useful for the economic decision-making.

However, if the tax legislation of the country establishes, for example, that this accounting expenditure (corresponding to a partial deterioration of the value of the inventory) will not be deductible for the purposes of income tax, but until the time when such deteriorated inventory is sold or self-consumed. Then such expense would have to be adjusted (added) in the tax conciliation of fiscal year 2018.[12]

For the fiscal year 2018, although it is true that the company has counted the deterioration of the inventory in accordance with IFRS (accounting technique), it has not yet been sold or consumed. For this reason, the taxpayer must consider such loss, for the moment, as a non-deductible expense in the tax conciliation with the expectation that it can be deductible later when the conditions required in the tax regulations are fulfilled.

Consequently, within the tax conciliation, the impairment loss of the value of $30,000 should be considered as an increase in the taxable basis (as a non-deductible income tax expense) in the 2018 tax return:

Countable Profit	xxxx
Tax reconciliation	
(+) Loss through fall in value	30.000

A temporary difference is generated between the accounting and the fiscal value, since, for tax purposes, they expect to deduct the $30,000 later (when the asset is recovered, i.e. when the inventory is sold or self-consumed)[13]. The taxpayer must register the respective deferred tax asset (the tax rate that is considered valid for the fiscal year in which the temporary difference is reversed is 22%). The deferred tax asset is $6,600 (i.e.: $30.000 * 22 %).

Accounting accounts	Debit	Credit
Deferred tax asset	6.600	
Income tax		6.600

This "deferred tax asset" registered as of December 31, 2018, represents the taxpayer's right to deduce (through tax reconciliation) in future fiscal years when calculating the income tax. The accounting record of this asset is made against the "income tax" which is the statement of results that should reflect not only the current fiscal consequences, but also the future fiscal consequences (i.e. the effects of deferred taxes).[14]

Although we have already accounted intuitively for the deferred tax asset, it is formally calculated using a methodology called the *"balance-based liabilities method"* referred to by IFRS. This methodology compares the "book value" of the different assets and liabilities of a company (which must be valued by applying the corresponding international standard)

[12] This is appropriate when the tax regulations of the country specifically clarify the tax treatment of losses due to partial deterioration of the value of the inventory. However, when a country has not been reformed (or clarified) the tax regulations considering the tax treatment of these concepts, then fiscal uncertainty arises, and in the absence of clarity, in practice some taxpayers have considered it as a deductible expense of income tax at the time that it is recorded in accounting, decreasing the taxable base.

[13] In IFRS, this difference is called ' deductible temporary difference '.

[14] Our main objective in this section is to develop in the reader a notion or intuition about the concept of deferred tax, explaining the reasoning behind this accounting record, because, in practice, for an appropriate domain and application of the deferred taxes, it is quite difficult-in the first instance-to understand the logical aspect underlying the accounting of these concepts.

against their respective “tax base” (which is the value attributed for tax purposes on such assets and liabilities). If there is a difference between the book value and the tax base, a difference (called “temporary difference”) will be generated, which is multiplied by the tax rate that is expected to be in force in the future (when the differences are reversed), generates a deferred tax (which may be a deferred tax asset or liability).

Next, we proceed to calculate the respective deferred tax asset in an orthodox manner using the “balance-based passive method”:

Book Value	Tax Base[15]	Temporary difference	Deferred tax
70.000	100.000	(30.000)	(6.600)

In 2019:

In the following fiscal year, in 2019, when the taxpayer sells his impaired inventory, he must carry out the following accounting records (according to the example’s background, the inventory was effectively sold at $70,000):

Accounts	Debit	Credit
Cash	70.000	
Income for sale of goods		70.000

Accounts	Debit	Credit
Sales cost	70.000	
Accumulated deterioration in the value of inventories	30.000	
Inventaries		100.000

In such a way that the deteriorated inventory has been completely discharged (including the asset corrector account), and the respective revenue and cost of sales are recognized[16].

It is to note that in 2019, the balance statement did not show a net report of this transaction, since the $70,000 posted as “income” from the sale are automatically compensated with the $70,000 recognized as “sales cost”.

However, the taxpayer has now complied with the conditions to deduct the $30,000 that he recorded in the previous fiscal year and that he recognized as a non-deductible income tax in that previous financial year, so how can he make deductible this concept now in 2019?

Let us remind that in fiscal year 2018, the taxpayer registered a deferred tax asset, which represents the possible deduction of an accounting expense that was previously recognized for tax purposes as non-deductible tax Income.

Then, in order to recover this tax deduction, the taxpayer must reverse (recover) the deferred tax asset in fiscal year 2019, as follows:

Countable accounts	Debit	Credit
Income tax	6.600	
Deferred tax asset		6.600

In parallel, the taxpayer must register the respective tax deduction within the “tax conciliation”, as well:

Countable Profit	xxxx
Tax reconciliation	
(-) Loss through fall in value	*(30.000)*

It is important to note that now the effect on the tax conciliation is negative (deduction), and therefore, it will decrease the taxable base (tax utility) in an amount of $30,000 in fiscal year 2019, generating an effective tax savings of $6,600 (Once applied the 22 % tax rate.)

[15] According to the IFRS, the tax base of an asset is the amount that will be deductible for tax purposes from the taxable economic benefits that the entity obtains in the future, when it recovers the carrying amount of that asset. If such economic benefits are not taxable, the tax base of the asset shall be equal to the amount in the books. In our example, for tax purposes, the entire cost of $100,000 of the inventory (i.e., the deteriorated part of $30,000, plus the remaining cost of $70,000) may be deductible later, at the time the sale or self-consumption occurs.

[16] IFRS does not include specifications on the accounting record of sales of impaired inventories. In practice, the use of a corrective account (for the accumulation of the deterioration of the inventory in the state of financial situation) is optional. However, it is recommended to use it. Another alternative could be to decrease directly the inventory’s account of historical cost. In any of the cases, when the impaired inventory is sold, its balance must be discontinued taking into account its deterioration of the value (as well as the decline of a deteriorated account receivable). Consequently, in the cost of sales (income statement) the net effect (cost less accumulated deterioration) will be recognized at the sale of the previously deteriorated inventory.

This way, the temporary difference would be reversed and the deferred tax asset would be recovered (through the tax reconciliation deduction of the tax year 2019).

6.2. Main cause of the registry of assets by deferred taxes

We have noted that deferred taxes arise from the differences in the financial and tax treatment of the same economic transaction.

In the particular case of deferred tax assets, these may be generated mainly by the fact that in the application of IFRS there are certain accounting expenses (or losses) that are the product of estimates based on principles (use of professional judgement and the best information available), as was the recent example of the impairment loss of the inventory value. Because it is an estimate (although it may be accurate or very good), a tax regulation could consider such expenditure or loss as non-deductible from the income tax so far-and to the extent that such estimates are end up becoming the reality (that is to say, when the facts become accomplished).

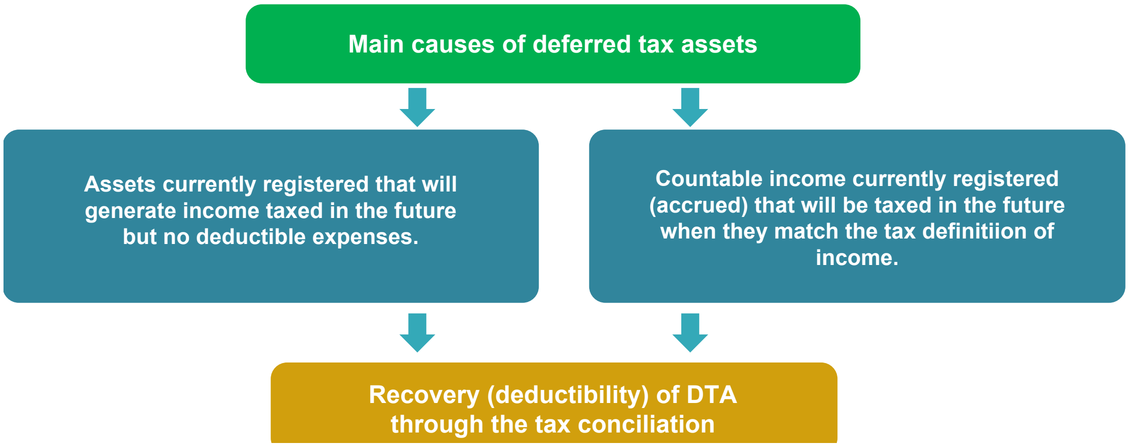
Another situation that may generate a deferred tax asset (i.e., a right to future tax deduction) is the fact that under IFRS there may be an accounting record of an expense (or a loss) without necessarily having a related countable income. For example, when an entity is in its pre-operative stage, the disbursements corresponding to this stage at the beginning of the activity (or the entity) must be directly accounted for as expenses in the income statement. Consequently, during this pre-operative stage, the entity may present losses in the balance statement at the end of the year. Therefore, IFRS do not necessarily work with a principle of associating income and expenditure.

However, from the experience gained by working with tax administrations, national tax regulations include usually a basic rule that provides that *an expense is deductible for income tax purposes whenever it is associated with a taxed income*. That is to say, the tax doctrine generally contemplates a principle of association income-expense for the determination of the taxable base of the income tax.

Consequently, a tax regulation could establish that pre-operational expenses will be deductible for income tax purposes at the time the entity begins to generate taxable income (taxed income), which may happen in an tax exercise later than the one in which the pre-operative expenses were recorded.

In this sense, the entity must consider as non-deductibles (in the tax conciliation) those pre-operative expenses in the fiscal year when no taxable income was generated (simultaneously registering a deferred tax asset). Then, to recover the deduction (via the tax conciliation) in the following fiscal year in which the taxable income is generated (by reversing at that time the deferred tax asset).

Figure 7: Main cause of deferred tax assets (DTAs)


Main causes of deferred tax assets
Assets currently registered that will generate income taxed in the future but no deductible expenses.
Countable income currently registered (accrued) that will be taxed in the future when they match the tax definitiion of income.
Recovery (deductibility) of DTA through the tax conciliation

To conclude this section corresponding to the deferred tax assets, it is important to indicate that its purpose has been to highlight the main reasons for the existence of deferred tax assets in practice. We note the differences between accounting and tax treatment and see how these differences can be reconciled. This is a framework of reference or guideline for the tax administrations. However, other causes that generate the accounting record of deferred tax assets may exist[17].

6.3. Deferred tax liabilities

In general, a deferred tax asset represents a tax deduction in future fiscal years (through tax reconciliation), resulting from the recovery of an asset or the liquidation of a liability.

To explain the functionality of the deferred tax asset, and how it allows the full compliance of IFRS and tax regulations simultaneously, let us consider a practical example.

Example: Measuring biological assets

During the fiscal year 2018, a taxpayer initially records a biological asset[18] worth $1,000. As of December 31, 2018, the taxpayer has incurred production costs directly related to the biological transformation of the asset, with a total value of $5,000. At the same date, the "fair value minus sales costs" of the biological asset is $10,000. The taxpayer sells the biological asset at the beginning of the year 2019 for a price of $10,000.[19] During 2019, the taxpayer did not incur any production cost for the biological transformation of the asset.

In 2018:

In the purchase of the biological asset, the taxpayer of the example must record the following accounting item:

Accounting	Debit	Credit
Biological assets	1.000	
Cash		1.000

For the accounting of production costs incurred in fiscal year 2018, the taxpayer may recognize them as expenditure on the statement of income in the year incurred, as follows[20]:

Accounting	Debit	Credit
Production costs	5.000	
Cash/Payable account Other accounts		5.000

By updating the accounting balance of the biological asset from $1,000 to $10,000 on December 31, 2018, the taxpayer may record a profit in the income statement by measuring the fair value minus the sales costs, at a value of $9,000, as shown below:

Accounting	Debit	Credit
Biological assets	9.000	
Profits measured at fair value Minus sales costs		9.000

Therefore, an operating utility of $4,000 ($9,000 – $5,000) will be generated in the balance statement. What tax treatment should be given to the registered countable profit and its associated production costs?

[17] For example, deferred tax assets may also be generated for tax losses and tax credits from previous periods, among others.

[18] A biological asset corresponds to a live animal or living plant that is used in an ' agricultural activity '. For example, livestock constitutes a biological asset for a farming company. Teak is also a biological asset for a forestry-focused company.

[19] In general, terms that can be assimilated as having to update the accounting balance of the biological asset to its market value (i.e. at a current value) at the end of the fiscal year.

[20] IFRS does not include specifications on the accounting treatment of subsequent agricultural expenditures (e.g., feeding costs, veterinary services, seeding, weeding, irrigation, fertilization, harvesting and slaughter). Therefore, the entities may choose to capitalize (activate) such costs. In practice, many entities recognize these "production costs" as expense (in the income statement) in the period in which they occur. For the example that we develop, we will apply this last approach.

If the country's tax regulations establish, for example, that this countable profit (corresponding to measuring the biological asset at its "fair value minus sales costs ") will not be taxed for the income tax until the moment that said assets are sold, then that profit must be adjusted (subtracted) in the tax reconciliation of the fiscal year 2018.[21] By consistency, if this type of earnings are not subject to the income tax (while the asset has not been sold), the associated production costs will neither be deductible from income tax until the time the biological asset is sold.

For the fiscal year 2018, although it is true that the company has posted gains and costs associated with the measurement of the biological asset in accordance with IFRS (accounting technique), it has not sold the asset (or disposed of it). For this reason, the taxpayer shall consider these accounting gains as non-taxable income for the time being, and their associated production costs as attributable to non-taxable income (i.e., non-deductible), both in the tax conciliation, with the expectation that they can be taxed and deducted respectively later, when the conditions established in the tax regulations are fulfilled.

Consequently, within the tax conciliation of the tax year 2018, the profit by measuring the biological asset at "fair value less sales costs" of $9,000 should be considered as a decrease of the taxable base (as income not object of income tax). In turn, the production costs associated with a total of $5,000 will represent an increase in the taxable base (as a non-deductible expenditure), as shown below:

Countable Profit	**xxxx**
Tax reconciliation	
(+) Profits by measurements at fair value minus sales costs	*9,000*
(-) Production costs	*(5,000)*

We note that the net effect on the items conciliation of the biological asset measurement is a non-taxable profit for $4,000. This represents, in essence, the operational utility about for which the taxpayer is not taxed now, but will be taxed in the future when the conditions established in the tax regulations are fulfilled (i.e. when the biological asset is sold).

Note that a temporary difference is generated between the accounting and the tax aspects, due to the $4,000 profit that is presented in the 2018 accounts but that will be taxed in a future fiscal year.[22] For this reason, the taxpayer must account for the respective deferred tax liability (the tax rate that is considered in force for the tax year in which the temporary difference is reversed is 22%). The deferred tax liability is $880 (i.e. $4,000 * 22%).

[21] This is appropriate when the tax legislation of the country specifically clarifies the tax treatment of earnings resulting from the measurement of biological assets at their ' fair value less sales costs '. However, when a country has not been reformed (or clarified) the tax regulations considering the tax treatment of these concepts, then there is tax uncertainty. In the absence of clarity, some taxpayers, by "conservatism" have declared the earnings by measuring at "fair value minus sales costs" as taxable income for the income tax, breaking the principle of "contributory capacity" and damaging the liquidity of the company. Because the taxpayer has not yet sold his biological assets, such accounting income has simply been generated by the updating to the ' market value ' of the biological asset, i.e. it is an accounting income by financial valuation, more not by a real sale. Because of the experience gained by working with control agencies in the public sector, this has resulted in the practice that in some countries some agricultural sectors are significantly harmed, affecting their working capital and preferring to measure the biological asset to the historical cost model (instead of market values). Let us remember that tax systems and their regulations have the main objectives of achieving economic stability and promoting the economic growth of a country. Additionally, by the principle of "neutrality" these new types of accounting records must not generate a minor-nor a higher-payment of income tax in relation to the tax amounts that were normally considered before the application of IFRS in each country, otherwise it would alter the economic behavior of the taxpayers and the functioning of the market. By causing distortions and not providing fiscal certainty for the application of IFRS, as shown by my recent experiences working as a consultant in the private sector, this has affected investors ' decisions when they evaluate in which country of the region to invest their capital. (They consider as more attractive those countries where the tax regulations provide all the clarity necessary to the new types of accounting records product of the application of the IFRS-product of legal stability).

[22] This difference is called "taxable temporary difference '.

[23] According to the IFRS, the tax base of an asset is the amount that will be deductible for tax purposes from the taxable economic benefits that the entity obtains in the future, when it recovers the book amount of that asset. If such economic benefits are not taxable, the tax base of the asset shall be equal to the amount in the books. In our example, for tax purposes, the value that will be deductible from income tax in relation to the biological asset, will be the costs incurred (in this case: the value paid to acquire the biological asset of $1,000 plus production costs incurred during fiscal year 2018, $5,000).

Accounting accounts	Debit	Credit
Income tax	880	
Deferred tax liability		880

While we have already calculated the deferred tax liability in an intuitive way, we can also do so in an orthodox way using the "balance-based liability method":

Book Value	Tax Base[23]	Temporary difference	Deferred Tax
10.000	6.000	4.000	880

This "deferred tax liability" registered as of December 31, 2018, represents a taxable effect (through tax conciliation) that the taxpayer has in future tax years for his calculation of the income tax. The accounting record of this asset is made against the "income tax"' which is the income statement that should reflect not only the current tax consequences, but also the future tax consequences (i.e. the effects of deferred taxes).

In 2019:

In the following tax year, in 2019, when the taxpayer sells his biological asset, he must write the following accounting records (according to the previous example, the inventory was effectively sold at $10,000):

Countable accounts	Debit	Credit
Cash	10.000	
Biological assets		10.000

In such a way that the biological asset has been completely discharged (coincidentally, it was sold to an amount equal to its last valuation in the accounting), and the respective receipt of the cash is recognized.[24] According to the background, the taxpayer did not incur in production costs associated with this biological asset in 2019, so no accounting record is made.

Note that in the 2019, there has not been a net affectation of this transaction in the balance statement, since the $4,000 that are generated as operating utility ($10,000 minus the costs incurred by the biological asset of $6,000 – including the purchase price), were recognized (but not taxed) in fiscal year 2018. So how can the taxpayer submit this (taxable) concept?

Let us remind that in the tax year 2018, the taxpayer has registered a deferred tax liability, which represents the future taxation of an operational profit (gross income minus production costs) that was previously recognized for tax purposes as no subject to income tax. Then, in order to comply with this tax obligation, the taxpayer must reverse (recover) the liability for the deferred tax in the tax year 2019, as follows:

Countable accounts	Debit	Credit
Deferred tax liability	880	
Income tax		880

In parallel, he must recognize the respective effect of encumbrance (or taxation) within the tax conciliation of the 2019, as follows:

Countable Profit	xxxx
Tax reconciliation	
(+) Profits by measurements at fair value minus sales costs	9,000
(-) Production costs	(5,000)

Note that in the tax conciliation, the net effect of the gross income of the biological asset measurement is now positive (taxation). The associated cost is negative (deduction), and therefore, in net terms, the taxable base will increase (tax utility) by an amount of $4,000 in fiscal year 2019, generating an effective tax payment (applying the rate of 22%) of $880 in that year, which relates to the operating income (income minus costs) that was not taxable in the previous fiscal year.

[24] IFRS does not include specifications on the accounting record of sales of biological inventories. In the IFRS training Material for SMEs developed by the education staff of the IFRS Foundation (the agency that oversees the activities of the International Accounting Standards Council – IASB), it can be seen that in the sales of the biological, the asset account is credited and the consideration received is directly recorded (in our example: Cash). If there is any difference between the amount of the consideration received and the balance of the biological asset that is credited, that difference must be recognized directly in results.

In this way, the temporary difference would be reversed and the deferred tax liability would be recovered (through taxation in the tax conciliation the tax year 2019).

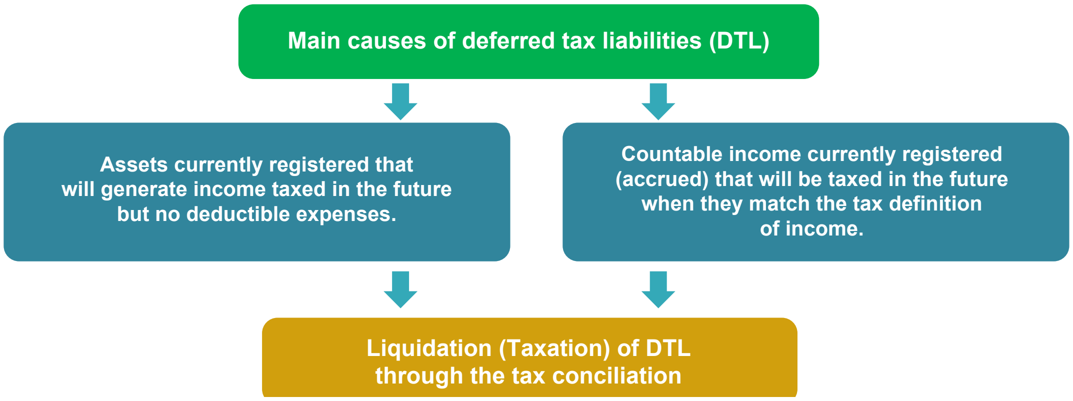
6.4. Main causes of the deferred tax liabilities registry

We have indicated that deferred taxes arise from the differences between the financial and the tax treatment of the same economic transaction.

In the particular case of deferred tax liabilities, these may be generated mainly by the fact that in the application of IFRS there are certain countable income (or earnings) that do not constitute an income for tax purposes, as was the case from the recent example of measuring the biological assets at their "fair value minus sales costs". This type of countable income could be taxed for tax purposes in another fiscal period; For example, when the related asset is sold. This will generate a taxable temporary difference (i.e., a value to be added later in the tax conciliation), and consequently, a deferred tax liability.

Another situation can generate a taxable temporary difference (i.e., values to be added later in the tax conciliation), and consequently, deferred tax liabilities. This happen when certain assets have been revalued for accounting purposes (Increasing their balance in books above the historical cost) but that, for tax purposes, the tax regulations could consider that the increased value of the asset (product of the revaluation) will not be deductible for calculating the taxable base of the income tax (although such asset generates taxable income). In such assets, the accounting value shall be higher than its tax base (i.e. the accounting value shall be greater than the future deductible values for tax purposes), and therefore a temporary difference shall be generated, which corresponds to the non-deductible values in the future when the asset will be recovered (for example, when depreciating). Because the future tax effect corresponds to values that will be added later in the tax conciliation, the type of difference that occurs is taxable, therefore, deferred tax liabilities are generated.

Figure 8: Main causes of deferred tax liabilities


Main causes of deferred tax liabilities (DTL)
Assets currently registered that will generate income taxed in the future but no deductible expenses.
Countable income currently registered (accrued) that will be taxed in the future when they match the tax definition of income.
Liquidation (Taxation) of DTL through the tax conciliation

To conclude this section corresponding to the deferred tax liabilities, it is important to indicate that the purpose of this has been to highlight the *main reasons* for the existence of deferred tax liabilities in practice. We note the differences between the accounting approach and the tax treatment. We see how these differences are reconciled in a framework of reference and orientation for the tax administrations. However, other causes may also generate the accounting record of deferred tax liabilities.

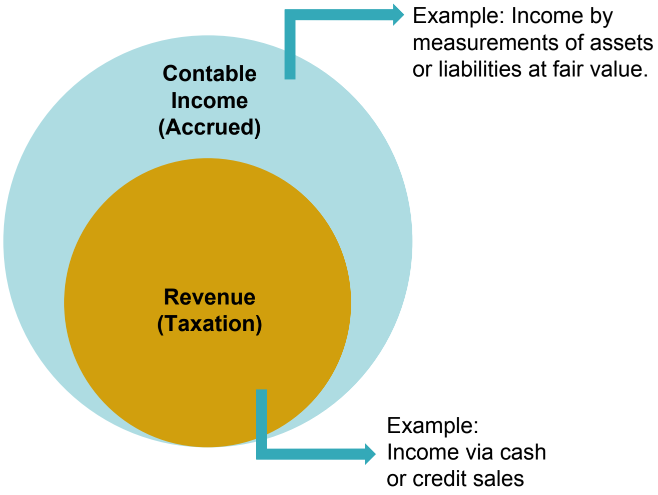
6.5 A reflection

At this point, the reader may ask why previously in Latin America the deferred tax assets or liabilities had not been recorded in the accounting. As you may notice, the accounting record of deferred taxes is subject to the simultaneous compliance with the financial rules and the tax regulations. However, before the application of IFRS in each country of the region, accounting had traditionally been *"turned into tax information"*, so there were virtually no temporary differences between the accounting and the tax.

7. DIFFERENCES BETWEEN COUNTABLE INCOME AND REVENUE

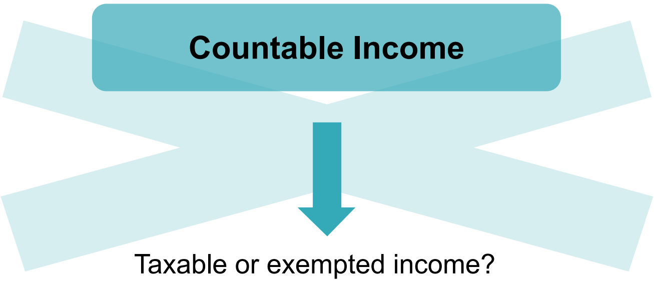
As the reader has already noticed, not all the countable income registered for the application of IFRS constitutes income from a tax viewpoint, as shown in Figure 9:

Figure 9: Countable income (accruals) and revenue (taxation)


Contable Income (Accrued)
Revenue (Taxation)
Example: Income by measurements of assets or liabilities at fair value.
Example: Income via cash or credit sales

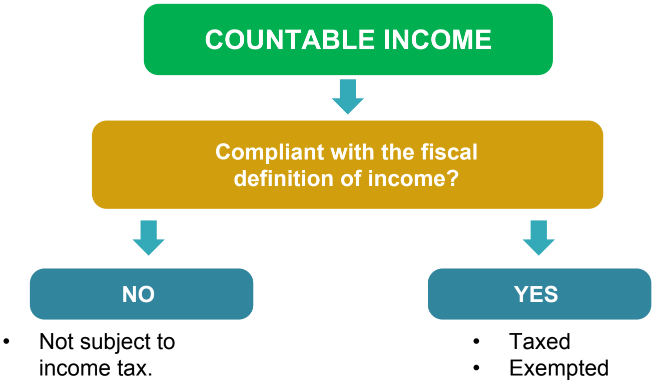
Therefore, it is important that the tax administrations bear in mind that at the time of analyzing and regulating the tax treatment of a countable income, the traditional analysis that evaluates directly whether the income is "taxed" or "exempt" income is no longer valid under the IFRS.

**Figure 10:
Traditional tax analysis
of countable income**


Countable Income
Taxable or exempted income?

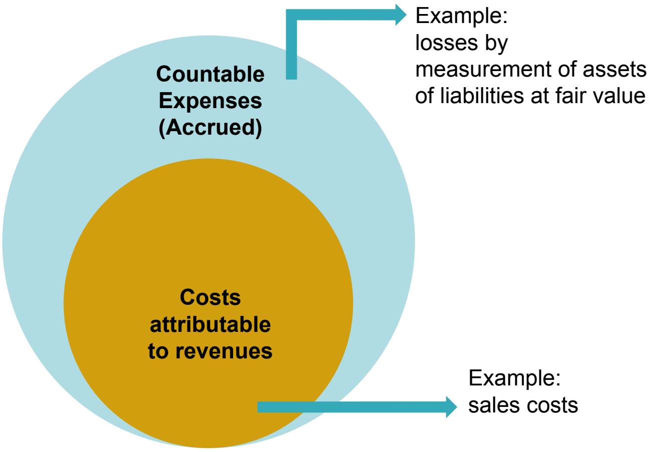
Therefore, tax administrations are encouraged to regulate the tax treatment of the countable income by evaluating in the first instance if that income complies with the tax definition of "income". If it does not comply, then the income is not under the scope of the tax (and therefore, it is an "income non subject to income tax") and if it complies, then we proceed to analyze whether it is taxed or exempted income, as shown in Figure 11 below:

**Figure 11:
A New approach
to tax analysis
of countable income**


COUNTABLE INCOME
Compliant with the fiscal definition of income?
NO
• Not subject to income tax.
YES
• Taxed
• Exempted

Likewise, it is necessary to regulate the tax treatment of the costs and expenses arising after the application of the IFRS associated with income, and associated with income “not subject to income tax”:

Figure 12:
Accounting expenses (accrued) and expenses attributable to income


Countable Expenses (Accrued)
Example: losses by measurement of assets of liabilities at fair value
Costs attributable to revenues
Example: sales costs

8. CONCLUSIONS

From this work, we can arrive at the following conclusions:

- Even if the financial regulations and the tax regulations pursue different objectives, they can coexist, through the tax conciliation and the deferred tax registration.

- The roles of both regulations do not overlap; rather, they complement each other: the action of the tax rules begins once the action of the financial regulation has ended.

- With the correct application of IFRS and tax regulations, a dual objective is achieved:

  - When entities prepare and present high-quality financial information, they can **take better economic decisions and they gain better access to capital**.

  - The calculation of the income tax takes as a starting point the accounting result, and to the extent that the IFRSs have been applied correctly and that the tax regulations of the country provide the clarity necessary to adjust this accounting result **the tax results generated will be appropriate**.

The accounting and tax professions, the companies and the supervisory bodies, currently face opportunities and challenges from the application of IFRS. We are fortunate to live in this time of important changes in our countries. Thanks to this paradigm shift that take place in Latin America, the present and new generations of taxpayers will be able to understand clearly the differences between the financial and tax regulations, what their objectives are, and how their differences should be reconciled.

While the *"tax conversion"* of financial accounting has been rooted for more than 30 years in our region, we fully trust that the process of *emancipating* accounting from taxation can be achieved fully over the years. A long journey starts with a first step, and together we can be agents of change in our exciting profession.

"Start by doing what is necessary, then what is possible, and suddenly you will find yourself doing the impossible".
San Francis of Assisi (1182 – 1226),
Italian deacon.

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DIVIDENDS AND PROFITS IN THE **URUGUAYAN TAX SYSTEM** AND THE RECENT INCORPORATION OF THE PRESUMPTIVE REGIME

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SYNOPSIS

In this paper, we analyze the tax treatment of dividends and profits in Uruguay, with the purpose of visualizing other options that may contribute to the improvement of the current system. In our opinion, the importance of the subject is that the more the system of determining the taxable amount and the tax liquidation is complex, the greater the difficulty of control, and those facts result in an incentive of non-compliance for the taxpayers and a potential loss of revenue for the Tax Administration (hereinafter TA).

CONTENT

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(It should be mentioned that what is expressed is our opinion and does not represent the position of the DGI)

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INTRODUCTION

Although the taxation of dividends and profits[1] has been the subject of tax policy analysis for a long time, the choice of the topic relies on two aspects. First: With respect to the dividends paid by the local companies, since the tax reform established in the year 2007 the resident individuals are taxed for this type of yields, and because of the low collection rate, a presumptive dividend regime was recently implemented, which represents a new aspect in our legislation. Second: With regard to the capital gains from abroad, since in the current reality more and more taxpayers operate globally, their control becomes more complex. However, it may be beneficial to use the information from the automatic exchange in order to control such yields.

Precisely, seeking to improve the tax treatment of dividends, Uruguay implemented the presumptive dividend regime and amended the provisions of transparency with respect to income obtained through non-resident entities (hereinafter NR). However, we need to continue advancing with a view to improve some critical points of the current standard, and to address new approaches, such as sub-capitalization.

In order to optimize the system and increase the collection with as fairly as possible, we took into consideration that in order to ensure the fiscal goal involved, the last tax corrections included increasing the taxable aspects of the dividends. In addition, that both fairness (so that there is no discrimination and that the contributory capacity of taxpayers is contemplated) and the control of evasion and avoidance are the tax policy objectives.

In synthesis, the work will be exposed with the following structure: In the first chapter, we develop the theoretical framework in which the dividends are framed in Uruguay, its evolution in time and its relation in a context of fiscal transparency. In the second chapter, we describe the tax treatment they receive, highlighting the most relevant aspects of local regulations and essentially in terms of the presumptive dividends regime and the International Fiscal Transparency Act. In the third chapter, we discuss the problem related to subcapitalization, analyzing the possibility of financing societies by integrating capital or through loans. Finally, we reach our conclusions and mention the bibliography.

It includes commentaries, legal and normative regulations, resolutions and consultations of the DGI, jurisprudence, and doctrinal works.

1. THEORETICAL FRAMEWORK OF THE TAX TREATMENT OF DIVIDENDS IN URUGUAY[2]

1.1 Evolution of the tax normative on dividends in Uruguay

From the tax point of view, dividends are defined as any distribution of profits as shareholders' capital remuneration, so the statutory decree states: *"The concept of dividend includes any distribution of profits to remunerate the shareholders' capital. In the case of capital redemption, the portion of the redeemed price, which exceeds the nominal value of the corresponding shares, shall be considered dividend. The distribution of dividends in shares of the company is excluded from this concept, unless such shares are redeemed in the two years after the distribution, or that such distribution is carried out within two years of a redemption"*.[3]

In the tax system in force until the year 2007, in the field of the Industry and Trade Income Tax (hereinafter IRIC from its acronym in Spanish), the distribution of dividends was rarely taxed. I was only taxed when they were "... *dividends or profits credited or paid by the taxable persons to individual or legal entities domiciled abroad, when they are taxed in the country of residence of the holder and there is tax credit for the taxes disbursed in the Republic* ". Those who were beneficiaries of such income were passive subjects (hereinafter PS) of IRIC from the moment of payment or credit, which made the triggering event instantaneous, giving rise to the corresponding tax obligation, at the

[1] In accordance with the majority doctrine, the dividends refer to the benefits distributed by the capital companies and the profits to the profits distributed by the personal societies. However, in the present work when we refer to the term dividends we mean both dividends and profits, unless expressly mentioned in the difference in terms.

[2] Regulation updated to 05/2017.

[3] Article 19 of Decree 148/007.

rate 30% of the amount paid or credited. However, when the foreign legal entity could not make use of the referred tax credit for having obtained a negative fiscal income, the income was considered exempt.

The Tax Reform Act[4] (hereinafter LRT in Spanish) involved a major change in the Uruguayan Tax System. With regard to the taxation of income, three main taxes were created[5]: Individual Income Tax (hereinafter IRPF in Spanish), Income Tax of Non-Residents (IRNR in Spanish) and Income Tax of Economic Activities (IRAE in Spanish). Thus, the LRT proposed to reduce the amount of taxes levied on income and in parallel to make sure that all income is taxed by some form of taxation.

In this sense, significant changes were also established in the treatment of dividends, which as we saw, were practically not taxed before. Although the original project submitted to the Assembly established a waiver of dividends on IRPF and IRNR, based on avoiding double taxation, as a result of the parliamentary process they finally ended up taxing them, arguing that this double taxation would be beneficial to promote reinvestment by companies.

Thus, a first hypothesis of taxation was added to the dividends derived from the holding of capital shares paid or credited by IRAE taxpayers that have been generated with income affected by said tax, accrued from 01/ 07/2007.[6] These are included in the concept of capital returns (Category I Income), taxed at the rate of 7% by IRPF if the shareholders are resident individuals, and by IRNR if they are non-resident entities.

The concept of taxed dividends includes those distributed by IRAE taxpayers who have been beneficiaries of dividends distributed by another taxpayer of the tax, if in the entity that made their first distribution; they have originated in income taxed by IRAE. This is an anti-avoidance rule that applies in situations where there is interposition of local entities, and arises because of the exonerated distribution of dividends among IRAE taxpayers.

The IRNR regulation includes, in addition, the situation of rotation of dividends between a Permanent Establishment (hereinafter PE) of a NR entity towards its parent company (hereinafter CM in Spanish) or to other branches, and those distributed by resident entities whose results included the participation of NR entities without PE in the Republic, for the part corresponding to those holders.

Law No. 18,718 of 24/12/2010 introduced an exception to the source principle[7], modifying the territorial aspect of the tax. From 01/01/2011, the IRPF taxes the income of movable capital originated in deposits, loans and in general any placement of capital or credit of any kind, as long as they come from NR entities. Therefore, for these incomes, the criterion of attribution of tax authority that points to the residence of the people was adopted, independently of the place of generation of the income (world income principle). Within the foreign source yields reached are included, for example, the interests of deposits in financial institutions or other foreign entities, interest in loans granted to NR entities, and dividends. Real estate capital gains or assets increases of foreign source are not included.

This law aims to adjust the New Tax System to ensure the achievement of the objectives for which it was designed. Regarding equity, it does not discriminate the tax treatment between local or foreign placements; And as a stimulus to investment, the law prioritizes local placements in order to channel the saving capacity of residents towards domestic investment. For this purpose, a single linear rate is fixed for this new taxation hypothesis, equal to the maximum rate of the category I income tax, and the reduced aliquots are maintained for certain local loans and investments.

[4] Law No. 18,083 of 27/12/2006.

[5] Previously a very high number of taxes that taxed the income, but multiple revenues were not taxed.

[6] Title 7 Art. 27 Lit. C. Taxability arises through an exception in the article where tax exemptions from IRPF are established and therefore, as a rule, dividends are exonerated.

[7] Prior to the approval of the said law, the taxes levied on the income were affiliated to the source principle, taxing income from developed activities, property located, or rights used in the country.

For its part, the text and context of Law No. 18.718 indicate that these foreign source income still included in the tax must have the status of passive income. Although neither the law nor the statutory decree provide a definition of passive income, it can be understood that they are those that come essentially from the capital factor without requiring the participation of the holder with his personal work.[8]

This is how the aforementioned standard adds a second hypothesis of taxation, stating that the dividends distributed by an PS of IRAE that originate in movable yields from abroad, when they are distributed to the individuals, will be taxed by IRPF at 12% rate.[9] This provision pursues an anti-avoidance purpose, by avoiding the interposition of a PS of IRAE between the individual and the foreign profits for not paying income tax in the distribution of the dividends originated in those, since they are not reached by IRAE for being a foreign source income.

Through the Regulatory decree[10], a third hypothesis of taxation provides that the dividends distributed by NR entities constitute rents of movable capital taxed by IRPF, and as such, income they are not subject to the imputation system.[11] This hypothesis derives from the extension of the source incorporated by Law Nº 18.718, which includes in the category I income "(...) *any placement of capital or credit of any kind, coming from NR entities*"... This situation includes, for example, the dividends received by an individual resident derived from a shareholding in a NR entity, when they are collected directly from a NR entity not located in a regime of low or zero taxation (tax haven, or BONT in Spanish). Note that these dividends are taxed regardless of their source and the income that produce them. This means that if the NR entity shared by a resident individual obtained income of Uruguayan source, it would be included in the IRNR, and the dividends originated would pay the IRPF. To solve the resulting double taxation, the law stipulates that the distribution of dividends made by NR entities originated in Uruguayan source income included in the IRNR be exempted from IRPF.

The Accountability Act of 2015[12] introduced new changes, in order to increase the taxable income for dividends and to pursue the reduction of tax evasion possibilities, while the data released by the DGI show that the vast majority of Uruguayan companies did not distribute profits in a formal way after the LRT. This generates a major damage to the Treasury, particularly in cases where there is no formal outflow of funds from the IRAE taxpayer.

Within the changes to IRPF and IRNR, the profits withdrawn by the owners of individual enterprises that obtain business income and whose income in the fiscal year exceeds the limit of 4 million of Indexed Units[13] (hereinafter IU) pay a 7% tax. The exemption is derogated for utilities distributed by personal service providers outside the labor dependency that have been included in IRAE in application of the option,[14] if their income exceeds 4 million IU. In addition, a system is included in which the net income taxed (hereinafter RNFG in Spanish) by IRAE that at the end of each fiscal year have an antiquity greater than three periods, will be imputed as presumptive dividends in the third month of the year following the calculation of the referred term.

In synthesis, in relation to the dividends there are three hypothesis of taxation, which will be developed according to the following structure. In the first two, the emphasis falls on the existence of an IRAE taxpayer and the underlying income: if they are generated in income taxed by IRAE, they will be taxed at 7% (section 2.1) and if they are generated in passive incomes from abroad, they will be taxed at 12% (section 2.2.1). In the third hypothesis, the IRAE taxpayer and the underlying

[8] Calleja, A. L, Camejo, C., Acosta, J.A., Bruzzone L. (2011). Foreign source income taxed by IRPF. Work presented at the IV Tax Conference, Montevideo, Uruguay, p. 11-13.

[9] Inc.1 of Lit.C of Art.27 of Title 7.

[10] Article 17 bis of Decree 148/007.

[11] Regime arranged in the Art. 7 bis of title 7.

[12] Act No. 19,438 of 14/10/2016.

[13] The UI is a unit of value that is being readjusted according to inflation measured by the consumer price index. Currently, the ceiling is equivalent to approximately USD 500,000.

[14] Option provided for in article 5 of Title 4.

income are left aside, since the taxable event occurs when a NR entity distributes dividends to resident individuals, who were not subject to the imputation regime and are taxed at 12 % (point 2.2.2.1). In each hypothesis, we will also analyze the possible case study that the regulation provide in case of interposition of entities.

1.2 Fiscal transparency in the international context and in Uruguay

After the 2008 financial crisis, the countries with greater economic power developed strong suspicions regarding bank secrecy, low-tax regimes (BONT), tax planning and tax evasion, among other issues. The Common Reporting Standard of the OECD is one of its initiatives to promote the automatic exchange of tax and financial information as a measure of fight against fraud and erosion in tax collection.

From 2018, Uruguay is committed to adhere to the automatic exchange of financial information for tax purposes, as an essential pillar for the international insertion. To this end, the International Fiscal Transparency Act (hereinafter LFTI in Spanish) was sanctioned[15], which establishes standards of convergence with international standards for international fiscal transparency and exchange of information for tax purposes, prevention of assets laundering and financing of terrorism.

In its first chapter, the law regulates the delivery of the automatic report of balances and income of financial origin to the TA. This, in order for the DGI to complete its tasks, as well as to proceed with the exchange of information (hereinafter IE) in the framework of a Double Taxation Convention (hereinafter DTC) or an Information Exchange Agreement (hereafter IEA). The residence for tax purposes must also be identified, as well as the account holders and final beneficiaries when applicable. The second chapter contains rules that seek the identification of the final beneficiary of the resident entities and the NR entities that have a sufficient link with the country. The third chapter incorporates tax rules aimed at discouraging the use of BONT entities, modifying the disposition of fiscal transparency regarding the income obtained by IRPF taxpayers through NR entities, which corresponds to assign the total of the capital yields and assets increments obtained by the NR entity to the IRPF taxpayer as dividends.

2. RELEVANT ASPECT OF THE NORMATIVE

2.1 Dividends paid by IRAE taxpayers generated in revenues taxed by IRAE

2.1.1 Determination and payment of the tax

As we have seen in point 1.1, since the Tax Reform (LRT), the dividends paid or credited by IRAE taxpayers and coming from income taxed by IRAE are taxed by IRPF or by IRNR at the rate of 7%. In turn, this hypothesis of taxation requires that their source income have been paid from 01/07/2007.

The distributed dividends corresponding to cumulative results of exercises initiated before 01/07/2007 will not be taxed, and shall be imputed in the first place to these accumulated results. The concept of cumulative results will comprise the accumulated accounting gains and losses without specific allocation, the legal reserves, the statutory ones, and in general, all those created according to the law of commercial companies[16] generated in the exercises initiated before 01/07/2007.

The regulation stipulates that once the accumulated non-taxed results have been exhausted, the distributed dividends will be imputed in the first place to the RNFG taxed by IRAE, accrued from the first fiscal year included in that tax, and until the exercise preceding 01/01/2011,[17] regardless of the exercise in which they were generated. This was interpreted this way by the DGI arguing that if there is tax income taxed by IRAE pending distribution, this income will be taxed. The interpretation of the standard is that there is a net income tax pending distribution, so if it is distributed

[15] Law N ° 19.484 of 05/01/2017.

[16] Law No. 16,060 of 04/09/1989.

[17] Date from which Law No. 18,718 becomes effective.

when there is no net tax income, it will not be taxed, but if there is net tax income, the distribution will be taxed. For practical purposes, a checking account must be used, impacted by the net tax income of each financial year at the time of the submission or expiration of the tax return. Once the return is filed or expired, the net tax income is incorporated to the current account with the corresponding sign and the company should take it in consideration at the time of distribution. If there is enough net tax income, it will be taxed up to the amount and the surplus is not taxed.

The text of the normative establishes that the tax losses of previous years will not be considered as part of the net tax income, which seeks to avoid their duplication by way of determination of the tax.

Likewise, the law contemplates the interposition of local entities in the same distribution of dividends originated in taxed income, considering it as taxed for the effects of the income tax. Therefore, at the time of distributing dividends, the RNFG must be added in the IRAE heading for the purposes of considering them for the taxation of individuals.

2.1.2 Presumptive dividends

Since the approval of the LRT, one of the major changes in the topic of dividends and profits is given by Law Nº 19.438 that incorporates the concept of "Presumptive Dividends and Profits".[18]

With the approval of the aforementioned law, it is expected to obtain a withholding of the IRPF or IRNR corresponding to the distribution of dividends through the application of a presumptive regime, which will be imputed now of the real distribution. The explanatory statement describes the problem as follows: although, since the LRT was enforced, the distributions of results originated in incomes taxed by IRAE are taxed by IRPF or by IRNR, according to the DGI's information, but in 2008-2014 only 15% of the companies that submit positive results have withheld and paid the aforementioned taxes, as a result of formal distributions. Of that 15%, less than 10% have made more than one distribution. Therefore, it is reasonable to consider that a significant number of companies included in the remaining 85% avoided formal distribution to avoid paying taxes, and may have channeled their withdrawal through other figures.

In summary, this new regime implies that the net tax income taxed by IRAE that at the end of each fiscal year is older than or equal to four exercises will be imputed as presumptive dividends.[19] As this regime entered into force on 01/03/2017, the first taxpayers reached were those who closed the exercise on 31/12/2016. The calculation to be made to determine whether to pay presumptive dividends by the year closed on 31/12/2016 is to determine the smallest amount between: a) the tax results from 01/01/2008 to 31/12/2012 and b) cumulative accounting results to 31/12/2016 (Both items calculated as shown below). If these two figures are positive, on the lesser one and in the third month of closing the exercise, 7% of IRPF or IRNR must be paid for "presumptive distribution".

The main points that emerge from the analysis of the standard are the following:

- Concerning the determination of the fiscal results:
  - The taxable net income referred to is that accumulated from the exercises initiated since 01/07/2007.
  - Previous tax losses will not be deducted for determining the amount of taxable net income.
  - Of the taxable tax net income, the following will be deducted:

i. Taxable dividends that come from revenues taxed by IRAE, accrued until the closing of the last fiscal year of the company.

ii. Putative dividends imputed in previous years, provided they have not been imputed to distributed dividends.

[18] Art. 16 bis and article 16 ter of Title 7 (IRPF); Art. 12 bis and art. 12 ter of Title 8 (IRNR).

[19] Although the law refers to an antiquity greater than three exercises, the executive power established a period longer than or equal to four exercises to clarify that the 2016 exercise is computed backwards as year 1.

iii. The amount of investments placed in assets of other resident entities,[20] in fixed and intangible assets[21], if the transferor is identified. These investments are those carried out in the exercises initiated from 01/07/2007 until the end of the last fiscal year. If such investments are alienated in the year in which they were carried out or in one of the following three periods, the cumulative tax net income will be added to the amount equivalent to the investment previously deducted. The definitions of the items are those corresponding to IRAE.

iv. The increase in gross working capital resulting from the comparison between the balance at the end of the last fiscal exercise and that of the first IRAE liquidation exercise adjusted by the consumer price index until that term. The aforementioned increase may not exceed 80% of the amount referred to in the preceding point. For this purpose, the difference between the sum of the credit balances for sales and inventory of current goods, and the current liabilities, valued according to IRAE rules will be considered as gross working capital.[22]

- The presumptive dividends determined according to the above are subject to an accounting limit, which is calculated as the cumulative results at the end of the fiscal year, deducting the presumptive dividends already taxed. For such purposes, the cumulative income concept comprises the accumulated accounting gains and losses without specific allocation and all reserves; as well as the accumulated income capitalizations and any other reduction in such results that does not imply a variation of the countable worth verified from 01/01/2016. [23]

- The presumptive dividends will be imputed in the first place to the accumulated results corresponding to exercises initiated before 01/07/2007, as long as they remain as such, not being taxed up to those results. In this way, the presumptive distribution receives the same treatment as the actual distribution.

- Presumptive dividends will be taxed in a proportion corresponding to each shareholder in accordance with the provisions of the social contract, in its absence, of the Commercial Companies Act.

- The case of an IRAE taxpayer being a shareholder of another IRAE taxpayer is included in the concept of presumptive dividends. In this hypothesis, if “B” is the holder of the actions of “A”, the taxpayer of IRAE “A” should analyze whether it verifies the hypothesis of having dividends pending distribution. In case of having them, they must be taxed as such and will be charged directly to the resident individual who is a shareholder of the IRAE taxpayer “B”. The IRAE taxpayer “B” must also carry out the aforementioned analysis. For such purposes, dividends received from IRAE taxpayer “A” will be considered as taxable income. In addition, if the calculation of presumptive dividends is correct, the amount already imputed by the IRAE “A” taxpayer must be subtracted. If there is a surplus, it will be imputed to future determinations. The entity that makes the first imputation must communicate the tax paid as presumptive dividends through a receipt.

- Are not reached by this levy: i) The net tax income obtained by the personal companies and one-person entities whose income, in the exercise that gives rise to the distribution, does not exceed the UI 4 million; ii) The taxpayers of IRAE and IMEBA whose

[20] Such as shares, social quotas, certificates of investments in trusts or investment funds, computed with the acquisition cost or the approved capital increase.

[21] The fixed asset shall be computed by the cost of acquisition, production or inclusion to the assets. Intangibles will be computed for the cost of acquisition.

[22] Sales receivables and liabilities shall be considered as currents when their completion or maturity is agreed to within 12 months of the closing date of the corresponding financial year. Exchange goods shall be considered as current when their realization is deemed to occur in the aforementioned term.

[23] Capitalizations made up to 31/12/2015 are not taken into account in the calculation base. However, to avoid the possibility of tampering with open books, it is not allowed computing subsequent capital gains, considering that if the company invested again they should have capitalized the accumulated accounting results.

shares are listed in stock exchanges authorized to operate in Uruguay. [24]

- The payments of IRPF or IRNR made for the presumptive dividends will be imputed to the IRPF or IRNR applicable to the dividends that are effectively distributed. Thus, the withholding on "real" dividends will be made via the difference between "presumptive" and "real". If the first are greater than the last, the surplus will be imputed to future "real" distributions. The regulation provides for the refund of the payment in excess only in cases of definitive settlement of the IRAE taxpayer, and of distributions in favor of a Public Law Entity or of a Pension Savings Fund.

- IRAE taxpayers are responsible for third-party tax obligations to determine the taxed dividends.[25] This obligation shall be of 7% and must be paid the month following the imputation. The balances corresponding to the presumptive dividends that the responsible maintain with the IRPF and IRNR taxpayers for taxes paid or agreed will not be considered active for the purposes of their liquidation of IRAE. In this way the IRAE taxpayer does not generate a credit against the shareholder, which after 18 months could be transformed into unrecoverable and therefore in a deductible expense of the company, leaving without effect the objective pursued.

Some considerations:

The "presumptive distribution" arises as a way to collect the tax originated in dividends that companies would not be paying to channel them through other figures. It is worth remembering that those companies opting to withdraw them in the form of loans are equally taxed, and in principle based on the economic reality, the TA could qualify those withdrawals as distributions. However, one must bear in mind that the position of the Contentious Administrative Court is that one must attend to the formal aspect of the distribution of the dividends, so that the TA might be obliged to accept the figures presented by the taxpayers. [26]

On the other hand, it should be remembered that one of the major changes of the LRT was the decline in the IRAE rate from 30% to 25%, subsequently taxing the withdrawal of money by shareholders at the rate of 7%, as a way of "encouraging" that the gains obtained remain within the entrepreneurial scope. Many companies were able to use this option, withholding the money in the company but without the need to increase their integrated capital and without having to make significant investments in fixed assets. Some companies that probably have the money withheld as a contingency reserve or planning an investment will now have to pay 7% for dividend distribution that, perhaps, when they were actually to distribute them in the end, most of them could have been consumed. That is to say that while the rule seeks to collect a tax that would be avoided through the use of other figures, it could also harm those companies that decided not to distribute in total harmony with the current rules.

In addition, given the recent entry into force of the concept of presumptive dividends, many questions remain for the purposes of practical application, and the position that adopts the TA will have to be defined. Here are some of the issues that we understand can be generated, as well as criticism of this new regime:

- The mechanics of the calculation may cause situations in which fixed assets fully amortized or assets that were already discharged (in this case, after the minimum period required by the standard) could be calculated as presumptive dividends. This complicates even more the information to be collected, mainly in this initial instance involving the analysis of many years carried back.

- Other types of investments, such as treasury bonds or equity stakes in foreign companies are not considered, because this is a finalist definition. However, for the investments appropriate to

[24] These exemptions are the same as those applicable to the regime for determining the taxed dividends and liquidation of the IRPF or the IRNR.

[25] Unless the holder of the shares is a public law entity or a pension fund, or when they are listed in official stock exchanges.

[26] Decision No. 665/2015 establishes that as long as the distribution project is not approved, there is no dividend distribution, and thus does not hamper the fact that the tax obligation is created.

consider, those computable are taken irrespective of whether they generate income that is not taxed or benefit from some type of exemption.

- In the parliamentary discussion it was understood that the scope of investments that were being incorporated for the calculation of the presumptive dividends were very restricted. Therefore, in order to give a greater benefit to the taxpayer, the investments made to increase the real value of the gross working capital were incorporated.

- The rule deviates from the accounting definition of the term working capital because it does not consider all the current assets. It also refers to increase rather than variation, so if there is a decrease in working capital, this should not be considered.

- With regard to the categorization of current assets, some activity changes may be particularly affected in the calculation of the presumptive dividend. For example, if due to the company's operations a significant part of the funds is reinvested in assets and are considered carried out within a period of more than 12 months, such as in agricultural and forestry activities.

- There is an inconsistency in the periods considered and in the form of valuation of the different concepts involved in the calculation of the presumptive dividends. Whereas, in order to determine the RNFG, the "real" dividends taxed, the computable investments and their disposals, the accumulated amounts from exercises initiated from the 01/07/2007 must be considered at historical values. However, to determine the increase in gross working capital, the variation is computed between the balance of the last fiscal year and that of the first IRAE liquidation exercise, adjusted by the consumer price index to that closure.[27] Although this incorporation had the objective of reducing the calculation for the benefit of the taxpayer, it generates the mentioned incongruence since inevitably, by its own definition; it includes balances at the end of the year. In order to maintain a coherence in the calculation, the standard should have established that in the variation the balance considered is at the beginning of the first IRAE exercise.

- Another issue is that the investments made or the distribution of real dividends are not considered between the three months since the closing of balance and until the date of computation of the presumptive dividends. They are considered only in the calculation of the following year, which generates a financial detriment to the taxpayer.

- The regime only reaches the dividends generated in revenues taxed by IRAE, which marks an inequity with those originated in income from movable capital from abroad in cases of interposition of a Uruguayan entity with sufficient accounting.[28]

- Likewise, by reaching only the income taxed by the IRAE, it seems that the computation of the payment of the tax by presumptive distribution is only for this type of revenue. Therefore, by the criterion of attribution of the dividends it could occur that even if there is a "credit" for the presumptive dividends, anyway they must pay dividends at the rate of 12% for the yields from abroad.

- Whereas the standard assimilates the presumptive dividends to a "down payment", the problem arises when the shares change ownership. For example, if the action is sold when the amount paid as presumptive dividend has not been imputed to the actual dividends because the distribution has not been made. It will be necessary to analyze if the buyer can use that advance payment made by the seller or if the down payment amount should be returned to the seller. In principle, it seems that whoever acquires the stake would be able to deduct the credit, since the amount paid in concept of presumptive dividend is deducted only when the distribution is made. This could lead to the thought that this tax on dividends, rather than a personal tax that taxes a person's profitability, is a real tax that taxes the profitability of a share. Even under this hypothesis, it could happen that there would be a cross between taxes. Thus for example, if a resident individual pays in advance the IRPF tax

[27] In case of balances closed to 31/12, the variation of the working capital would be computed since 31/12/2008, while the other concepts since the 01/01/2008.

[28] This inequity would not exist in the other cases since, if tax transparency were applied, or the rule that presumes the accrual of the dividends attributed to the individual at the time of the payment or made available to the beneficiary of the fund is applied, in both cases, they are imputed in advance as dividends.

for the presumptive dividends and then alienates his participation to a NR, this one on occasion of the real distribution will be taxed with IRNR, but we wonder if he could impute the IRPF prepaid by the seller.

- Finally, in order to qualify these presumptive dividends in the framework of a DTC, it should be determined which article of the OECD Model Convention to avoid the double taxation or of the United Nations Model Convention would include them, and this is an analysis that would exceed the objective of this work.

2.2 Profits from movable capital from abroad

Because of having taxed the yields of capital from abroad, Law No. 18.718 incorporate a series of anti-avoidance measures in order to neutralize the practices of interposition of legal entities to evade the payment of the tax and uses two instruments: Fiscal transparency or taxing the distribution of dividends of intermediary companies.

The standard of fiscal transparency[29] requires as a condition that the NR entity is BONT, and that the capital received is a return on capital of foreign source that constitutes passive rents. This standard, predecessor of the LTFI, defines the BONT entity as resident in a country in which the incomes are subject to an effective taxation inferior to the maximum rate in force for the income of capital in IRPF, or 12%. This effective taxation criterion previously used to determine when a system is of privileged taxation, made our country more aligned with the objectives of the controlled Foreign Corporations standards.

In this way, it is sought to avoid that an individual resident in Uruguay who obtains these yields, by interposing a BONT society, could make them rest without time restriction. To this end, the rule ignores the existence of this society, and maintaining the nature of the income, taxes directly this individual.

The standard of interposition of local entities and BONTT[30] entities stipulates that when a taxpayer of IRAE participates in the shareholding of a NR entity and verifies the hypothesis of low taxation, the returns of movable foreign capital constitute passive income obtained by the NR entity. They will be imputed to the taxpayer of IRAE, only for determining the dividends taxed by IRPF. In the same way, when a resident individual participates in the shareholding of a NR entity that verifies the low taxation hypothesis and this one receives from a IRAE taxpayer dividends corresponding to movable capital coming from NR entities and constitute passive incomes, they will be imputed in all cases to the aforementioned individual as own income. The standard applies fiscal transparency, ignoring the existence of the BONT society.

The LTFI introduces some changes in the rules described and, in its third chapter, incorporates tax rules aimed at discouraging the use of BONT entities. In this sense, it modifies the disposition of tax transparency with respect to the income obtained by taxpayers of the IRPF through NR entities, establishing that it is appropriate to assign them as dividends the total of the capital yields and increments in assets obtained by the NR entity. It also modifies the spatial aspect of the IRPF, IRAE and IRNR, considering of Uruguayan source the incomes corresponding to the transmission of shares and other shareholdings of BONT entities, as well as the constitution and cession of their benefits, if these companies have more than 50% of their assets in Uruguay.

The law in turn changes the definition of BONT countries or jurisdictions, stating that ''... *countries, jurisdictions or special regimes of low or no taxation shall be considered as low or null taxation jurisdictions which do not meet the requirements of the Minimum effective taxation or levels of collaboration and transparency determined by the executive power. "Making* use of this authority, the executive power stipulated that countries, jurisdictions or regimes of

[29] Article 7 bis of title 7 (in the drafting prior to the validity of the LTFI).

[30] Inc. 3 Lit. C of article 27 of title 7 (in the drafting prior to the validity of the LTFI).

low or null taxation are those which they verify the following conditions. 1) To submit the incomes from developed activities, goods Located or rights used economically in the Republic, to an effective income tax of less than the rate of 12%; and 2) Absence of or IEA or DTC with an exchange of information clause with the Republic in force or, if in force, is not fully applicable to all taxes covered by the agreement. Likewise, those countries or jurisdictions that do not effectively comply with the exchange of information are included in this concept. The decree instructs the DGI to draw up a list of countries, jurisdictions and special regimes that meet the aforementioned conditions.[31]

The following will analyze the different scenarios envisaged, for which the current regulations will be exposed to the LTFI,[32] and then the changes imposed by the recently approved law.

2.2.1 Dividends paid by IRAE taxpayers generated in movable yields from abroad

2.2.1.1 Interposition of an Uruguayan entity

In this hypothesis,[33] the resident individual participates in the capital of an PS of IRAE that receives the passive incomes from abroad, and when it distribute the dividends originated in those income, they will pay income tax at a rate of 12%, having the same tax rate than if the individual had a direct investment abroad.

The analyzed provision has an anti-avoidance purpose. In effect, in the situation prior to law No. 18.718, if a resident individual participated in the capital of a PS of IRAE that obtained yields for an external placement, in the field of the aforementioned tax it was a foreign source income. In turn, when the company distributed dividends, the individual was not taxed by the IRPF because they originated in incomes not taxed by IRAE. To avoid this situation it was stipulated that when an PS of IRAE obtain those capital yields from abroad, the dividends originated will pay IRPF, but no longer at the rate of 7% like the dividends originated in revenues taxed by IRAE.

The standard establishes a taxation on the distribution of dividends to a resident individual. The movable capital yields from abroad are not reached by any tax under PS of IRAE. A mutation in the qualification of income takes place, from being a capital yield from abroad originated in any type of placement or credit, to one of Uruguayan source originated in the participation in the capital of a PS of IRAE.

There are in principle two primary legal requirements in this taxation case. On the one hand, there has to be a PS of IRAE and on the other hand, the underlying income to the distributed dividend must be a passive income from abroad. However, the statutory decree establishes as a third requirement that the PS of IRAE should be verified to answer a number of conditions. Thus, the scope of taxability is restricted to provide a more benevolent treatment to cases where investment or placement abroad is due to genuine business activity, contrasting them with those in which the PS of IRAE is being used as an instrument for channeling the placement abroad and not being taxed.

A PS of IRAE will be automatically "qualified"' as such, when it obtains capital gains from abroad exclusively or in combination with other pure income from the capital or labor factor. In addition, the PS of IRAE are also considered "qualified" to obtain such yields in combination with corporate income, but in this case only if the TA proves that the company was used as a legal vehicle to channel investments from the individual abroad.

Since in this hypothesis the aliquot applicable to the income is 12% and the aliquot used in the distribution of dividends taxed by IRAE is 7%, the legislator amended the existing order of imputation and analyzed in point 2.1.1, taking into account the time when they originated

[31] Resolution No 1315/017 dated 14/03/2017. It includes such a list and establishes that the countries, jurisdictions and special regimes identified will be excluded from the entry into force of the exchange of information on request, and when the automatic exchange of information on financial accounts for tax purposes will be activated bilaterally by the Ministry of Economy and Finance.

[32] With the definition of the BONT regimes by the mechanism of the effective taxation rate.

[33] Inc.1 of Lit.C of Art.27 of Title 7.

and the type of income that generated them. If we were faced with a "qualified" PS of IRAE, the question to be asked is what rate applies in the distribution of dividends. In this sense, the regulation establishes the following order of imputation, adding two steps to the existing ones until the sanction of the Law nº 18.718. In the first place, they are imputed to the accumulated accounting results originated in the IRIC. Once exhausted, they are imputed to the RNFG by IRAE accrued since the first exercise taxed by IRAE until the previous year to the beginning from the 01/01/2011. Thirdly, as long as it is a "qualified" PS of IRAE, it is imputed to the external capital yields that constitute passive income. If the distribution exceeded the aforementioned brackets, it is again imputed to the RNFG of IRAE accrued in exercises initiated from 01/01/2011. Finally, if a surplus still exist, it would not be taxed.

It must be taken into account that the amount to be distributed arises from the accounting utility; therefore, it may occur that the amounts of the four levels of imputation are not exhausted and that final balances are generated in any of them, which must be taken into account as initial balances in future distributions.

The analysis carried out so far was considering that the shareholders are individuals resident in the country. If there are other NR shareholders, it is necessary to pay attention to the percentage that each one has in order to provide the distribution of dividends taxed by IRPF or IRNR. As we saw, the IRNR only taxes dividends generated in revenues taxed by IRAE, since, the extension of the source for the capital yields from abroad was only introduced in the IRPF. Therefore, the IRNR has a simpler order of imputation because the third step previously exposed does not exist. Hence, the importance of knowing the percentage of participation of the resident and NR shareholders, because although the foreign returns are considered paid for all the shareholders, the third bracket is only going to be taxed as IRPF in the percentage of the residents.

With regard to the criterion of temporary attribution of dividends originating in capital revenue from abroad, the regulation distinguishes two situations depending on whether or not the entity has sufficient accounting. If there is sufficient accounting, dividends are deemed paid when the competent social body or partners have resolved such distribution. In other words, the solution is identical in the case of dividends generated in income taxed by IRAE.

On the other hand, if the entity does not have sufficient accounting, the dividends are considered distributed at the time of the accrual of the incomes that give them origin. According to the general rule of payment of this type of yields, dividends should be presumed distributed when the payment is made or the availability of the yields from outside to the PS of IRAE. Therefore, when the PS of IRAE receives the payment or has the foreign yields available, the fiction that the individual is receiving them must take place. Thus, dividends will be presumed distributed even if such distribution has not been resolved. This provision implies an exception to the general criterion of accrual of dividends but it is not a new hypothesis of taxability, therefore when the distribution is resolved they will not be taxed by the IRPF.

The payment of the tax is performed through the withholding made by the PS OF IRAE.

Some considerations:

- With regard to the "qualified" PS of IRAE, in our opinion there is a situation of inequity generated by the condition provided by the statutory decree. While the SP IRAE that qualify have to withhold 12% for the income from abroad, those who do not qualify until the TA proves their qualification do not have to do so, being that in the light of the law everyone should withhold. However, of course, since the rule seeks to prevent tax avoidance, it does not seem reasonable to tax any distribution for the mere fact that it comes from abroad if the reality shows that the investment is part of the commercial activity of the company.

- In case of being before a "qualified" PS of IRAE, with the purpose of imputing the foreign yields the standard established a cut in the original order of imputation and, in consonance with the objective to encourage the placements in the country, followed somehow a chronological order of income generation. This new step is to be more burdensome for the taxpayer, since it is taxed at the rate of 12% and must be imputed before continuing to deplete the RNFG by IRAE, which reach 7%.

- With respect to the time of the income accruing, in the event that the PS of IRAE liquidates through sufficient accounting, we should ask whether the temporary attribution should not be equal to that of a taxpayer without sufficient accounting. This because in the first case there is a deferred payment of the tax and in the second case the payment is made before the actual distribution. Since the PS of IRAE possesses the payment information or makes available to the passive incomes, for being the one who receives them, it would be possible that in all the cases the payment of the tax is carried out according to that fact.

- Finally, it should be mentioned that in the framework of an inspection it is possible to identify the yields from abroad and the countries from which they come, a tool that could be used is the exchange of information. However, what can be verified with this proceeding is only a few points of the issue, such as the beneficiary of the income, the type of revenues concerned, the moment in which they were received, their quantification and their integrity. In turn, a limitation arises because the use of this tool depends on our country having a DTC or an EIA with the countries involved.

  Perhaps with the implementation of the LTFI and with the accession by Uruguay to the exchange of automatic information, a resource of greater efficiency, it would be possible to know what income and balances abroad are owned by the PS of IRAE, and with the identification of the final beneficiary, the resident individual involved will be known. However, this information could only be accessed in the context of a control action, thereby reducing the universe of taxpayers to which it can be applied.

2.2.1.2 Interposition of an Uruguayan entity and after a BONT foreign entity that receives the passive income

In this hypothesis,[34] the resident individual participates in a Uruguayan entity that is a "qualified" PS of IRAE. In turn, it has participation in a foreign entity that receives passive income from abroad. The peculiarity of the foreign entity is that it is subject to a BONT regime. For this corporate scheme, the standard establishes that the passive income received by the BONT entity will be imputed to the PS of IRAE in the only effect of determining the dividends taxed on the individual, that is to say that fiscal transparency is applied. When the "qualified" PS of IRAE distribute dividends to the individual, they will be taxed at 12%.

As for the imputation of the dividends distributed and the payment of the resulting tax, the analysis of the previous point applies (2.2.1.1).

In relation to the criterion of temporary attribution of the imputed incomes, although the standard did not envisage a particular criterion of a harmonic normative interpretation for this hypothesis, for the doctrine it is permissible to argue that the imputation of the income occur at the time they are received by the NR entity.[35]

With regard to the criterion of temporal attribution of the dividends, the analysis in the point 2.2.1.1 is applicable. It should be pointed out that when the PS of IRAE does not have sufficient accounting, the passive incomes are transparent, and from the temporal point of view, the chain continues to reach the resident individual directly.

The standard provides for the interposition of other PS of IRAE and other BONT entities, stating that the fiscal transparency and the imputation regime analyzed will be operational. Therefore, a multiple transparency implies recognizing the income of the individual at the time that it is received by the first entity BONT.

Some considerations:

- One can notice the difficulty of knowing the payment of income as long as the "qualified" PS of IRAE does not liquidate via sufficient accounting and, in all cases, of their imputation to the PS of IRAE, since, unlike the point 2.2.1.1, both occur when the NR entity receives the passive income.

  This problem relates to the requirements established by the Uruguayan regulations for the application of fiscal transparency clauses. Indeed, not requiring

[34] Inc.3 of Lit.C of Art.27 of Title 7.

[35] Calleja, et al., op cit, p. 27.

that the SP of IRAE should control the foreign society or have significant participation in it, although it can simplify the analysis, can also generate situations in which revenues are imputed to subjects who do not possess the power to dispose of them, creating a practical problem for having the necessary information to liquidate the tax.[36] In the case of a minority shareholder, access to information on the amount of passive income is difficult as well as at the time when such income should be considered paid in the event of insufficient accounting. Since the PS of IRAE must carry out the individual's tax withholding, the lack of information affects negatively its determination, generating fiscal risk in the collection.

- It is difficult to control, since the DGI will have to detect the shares of PS of IRAE in the BONT entities and what type of income these entities receive abroad. In the resolution of this point, the information that can be obtained from the information exchange mechanism may be useful, provided that our country has a DTC or IEA with the country where those reside. However, it is worth saying that when it comes to resolving the inspections, the answer is not always timely.

  Perhaps in this case the LTFI allows knowing if the PS of IRAE is informed as final beneficiary. However, not all NR entities have the obligation to inform their final beneficiary, and this coupled with the inability to obtain automatic financial information on the passive income of the BONT entity from which it participates, hinders the tax control by the TA.

- In reference to the passive nature of the income obtained by the transparent entity, it is noteworthy that our country is in line with the international practice of transparency.

2.2.1.3 *Interposition of a BONT foreign entity and later of an Uruguayan entity that receives the passive income*

In this hypothesis,[37] the resident individual participates in a BONT entity, which in turn is a shareholder of a PS OF IRAE that must be "qualified" and that receives passive income from deposits, loans or any other placement from abroad. In this case, again the norm uses clauses of fiscal transparency and the dividends distributed by the PS of IRAE to the entity BONT, will be imputed, to all the effects, as owned by the individuals.

As for the allocation of distributed dividends, at the time that the PS of IRAE resolves the distribution to the BONT, it must impute the extraterritorial passive income to the individual, as it was analyzed in the point 2.2.1.1. We also refer to that numeral in relation to the temporary attribution of the dividends to the resident individual.

In turn, when the BONT entity effectively distributes the dividends to the individual, in order to avoid a double taxation, the law exonerates them since they were already imputed to that individual.

Some considerations:

- The peculiarity of this case, unlike the one analyzed in the previous point, is that a withholding agent has not been designated, because beyond the fiction that the standard performs, the PS of IRAE distributes it to a NR entity, not to the individual. Therefore, because there is no designated responsible SP, the resident individual will have to declare and pay the IRPF.

- However, it is possible to ask whether the PS of IRAE could perform the withholding to the individual. Although he knows the amount of passive income he receives, he is not aware of who the shareholders of the NR entity are. The accrual of the tax is generated much before the cash collection of the dividends, since the same occurs when the PS of

[36] Calleja, et al., op cit, p. 16.

[37] Title 7 Art. 27 Lit. C INC. 3.

IRAE performs the distribution to the BONT entity or receives the income from abroad, if he has or not sufficient accounting, respectively.

- As in all cases of interposition of entities, access to information is difficult, as the individual to pay the tax should know at what point the PS of IRAE received passive income from abroad or distributed dividends of the same origin. This difficulty increases if the participation of the individual in the BONT entity is such that there is no effective control over it.

- The non-existence of a withholding agent and the difficulties caused by the audit of the tax to the individual increases the tax risk of collecting the tax. The problem is to establish how the DGI can learn of investments of the individual abroad. The exchange of information established by DTC or by IEA cannot be used, since they would not know which country to request. Therefore, the control of the IRPF would arise in the framework of inspections carried out to the PS of IRAE, in which the TA would gain knowledge of the existence of passive incomes, as well as of the owners of their capital.

- In this hypothesis the provisions of the LTFI on identification of the final beneficiary, which we will analyze below, will be used as tools of control.

2.2.1.4 Changes introduced by the TFI law

The LTFI replaces the third subparagraph of the literal C) of article 27, title 7, as follows:

- In the first part (corresponding to the 2.2.1.2 point), stating that when an PS of IRAE participates in a BONT entity and this one obtains capital yields and assets increments, those income will be allocated as dividends to the PS of IRAE to the single effect of determining the dividends taxed to the individual as IRPF. This means that they are included in the definition of passive income, in addition to the yields of capital, real estate capital gains and equity increases, for which the provisions set by the IRPF normative will serve for their assessment.

- In the second part (corresponding to the point 2.2.1.3), establishing that, in the same way, when a resident individual participates in the shares or assets of a BONT entity and receives dividends distributed by an PS of IRAE (who receives the yields of capital from abroad), they will be assigned to the individual.

This way, when the individual invests abroad by interposing a BONT entity, in order to determine the dividends taxed by IRPF, the revenues are no longer “imputed” to the PS OF IRAE (that is transparent, implying that it does not change the nature of the income), but are “allocated as dividends”. (That is, they are requalified, mutating the type of income). This means that the foreign income will be taxed by IRPF at the time they are received by the BONT entity in the first case), or by the PS of IRAE (in the second case, without sufficient accounting). If the PS OF IRAE has sufficient accounting, the dividend is allocated at the time of the distribution to the BONT entity, as if it were charged by the individual, so that it never “passes” by that entity from outside to defer the setting of the tax. Also, not only are the capital yields included, but also all the revenues obtained by the BONT.

In practice, the effect is that increases the taxable base of IRPF because, for example, if the entity BONT sells shares or leases a property abroad, the individual will pay the corresponding income tax at the time the entity BONT receives such income.

The objective sought with this change is to avoid that any passive income can “rest” in the BONT or in the PS of IRAE, so that the individual when using the entities BONT as an instrument differ their taxation for that income, unlike that the individual that invests directly abroad (case 2.2.2.1).[38] Indeed, in the previous situation, if the BONT entity received returns of real estate by the leasing of a property abroad, it did not apply the standard of transparency because it was not a performance of movable capital. On the other hand, only when the BONT entity decided to distribute dividends, it was sent to the individual and it was taxed by IRPF because it was capital yields. The rule was clear in the sense that this occurred at the time when foreign

[38] In this case, only the passive income perceived by the foreign entity is taxed.

incomes were received. Therefore, if the BONT decided to reinvest and not receive the income, the transparency did not apply.

Some considerations:

- The difficulty is maintained that the PS of IRAE must become aware of the moment in which the BONT receives the income of capital, as well as its amount and nature, which will depend on the percentage of control exerted by that entity.

- While the rules on transparency of international taxation in pure form refer to income of a passive nature, some countries have incorporated certain business income obtained in countries with privileged regimes. In the new system of income allocation to the individual, it is possible to question why the range of revenues does not also cover income of a business nature.

- It is to be emphasized that although the standard has advanced in incorporating other types of income for imputation, the same shortcomings and difficulties that the previous legislation suffered keep existing, in that there is no tax withholding agent, and the ignorance of the individual as to when they are paid.

- With regard to the new definition of a BONT, Uruguay is similar to other countries in which, for example, the degree of cooperation of States with regard to the signing of DTC or IEA is taken into account. In turn, in this way our country obeys international standards, which promote the incorporation of "cooperating" and "non-cooperating" jurisdictions in relation to tax transparency, according to certain conditions or characteristics. However, the conditions established by the Decree generate great practical difficulties in determining whether an entity should be considered BONT. The main complications are that precise knowledge should be given of the tax regime applied by the country in which the counterpart resides or if the country is effectively complying within the framework of an information exchange agreement.

Given the complexity of the issue, we understand that the decision of the executive power to entrust the DGI with the elaboration of a list of countries, jurisdictions and special regimes that satisfy the aforementioned conditions was successful in order to give certainty to the taxpayers. However, taking into account the dynamism of the phenomenon of international tax competition, in comparative law it is argued that they do not constitute an efficient, complete or adequate form to combat the tax deferral and the tax avoidance by income of foreign source.[39] That is why we understand that the list of countries should not be closed and the TA should keep it up to date.

2.2.2 Direct investments made abroad by resident individuals

2.2.2.1 Passive income obtained from a non-resident entity

This third hypothesis[40] of taxation does not consider either the existence of a PS of IRAE or the underlying income. In this case, the resident individual receives an income derived from a capital or credit placement abroad, which the standard considers as a passive income. In this type of income are included the dividends derived from the share in the capital that owns the individual in a NR entity, irrespective of the nature of the revenues that give rise to such items. Therefore, when the standard extended the source of the capital yields from abroad included this case, taxing those yields to 12% from 01/01/2011.

The standard imposes the dividends distributed by NR entities will be movable capital income, as such rents are not subject to the system of imputation, that is that the NR entity is not BONT. The reason for this provision is to avoid the interposition of these types of entities for the avoidance or deferred payment of the tax by the location of the passive income in countries of low or no taxation.

From the point of view of the temporary assignment, it is established that the yields are paid either when the taxpayer can access them, because they made the

[39] Bernal, C. (2015). Transparencia Fiscal Internacional. Trabajo Final de grado Universidad de Alcalá. Papeles de discusión IELAT, N°13, Madrid, España.

[40] Título7 Art. 3 Num. 2.

payment or because the paying institution made them available.

There are some residual cases of withholding agents such as financial intermediation institutions, and in general, all entities that act in the country on account and order of third parties and who pay or make available capital returns from abroad. When this condition is not fulfilled but the taxpayer operates through them, he or she may agree with these entities to perform the withholding. In the event that there is no official withholding agent, the payment of the tax is subject solely to the voluntary compliance of the taxpayer.

Some considerations:

- It is difficult for the TA to have knowledge of the moment when the individual receives the income from abroad and its amount. However, the LTFI establishes that certain financial institutions are obliged to inform the DGI of the balances and incomes at the end of the calendar year, of the duly identified accounts maintained by individuals, legal, or other entities, residents and NR. This facilitates the control of the payment of the tax and the identification of the beneficiary of the income.

- In turn, given the inverse reciprocity of automatic exchange of information to which our country pledged to subscribe, we can argue that it is useful to access the balances and rents owned by the residents of our country in foreign financial institutions. We understand that this way, people who have accounts abroad could be identified in order to be able to control the balances and the types of income. This could merit a further exchange in the context of an inspection to clarify the nature of such balances.

- In addition, another possibility of identifying potential beneficiaries is through the provisions established in the LTFI, in chapter II on the identification of the final beneficiary. NR entities complying with any of the conditions therein are obliged to inform and identify their final beneficiaries before the Central Bank of Uruguay. The obligation to report includes the percentage of the final beneficiary's participation, the percentage of those who are not, or are not known to be, and those who exercise the final control. In addition, if corresponding, the chain of ownership. The DGI has access to all this information, within the framework of an inspection. Notwithstanding the foregoing, we note that individuals who possess less than 15% of the capital of these entities remain outside the definition of final beneficiary. The fiscal transparency and the extension of the source in the IRPF apply without requirement of minimal participation, so we see that the TA will not access all the information necessary to control the tax.

- In addition, the standard also exempts certain NR entities from report and identification to the Central Bank of Uruguay. At the same time, it grants the executive power to exempt other entities that, depending on their nature and capital composition, are low-risk in the area of asset laundering and tax evasion, and, since this is precisely the objective of the LTFI, harmonization and application with the dividend distribution rules are difficult.

2.2.2.2 Interposition of a BONT entity that receives the passive income

In this case[41], BONT entities are interposed between the individual and the NR entity that pays the passive incomes, of which the first participates. Without prejudice to the changes that will be dealt with in the following paragraph, the previous regulation establishes a clause of fiscal transparency through which the existence of the BONT entity is ignored, and the returns of movable capital that obtains the will be imputed as the belonging to the individual. The legislator foresaw that by interposing this type of company the yields would move towards countries where the taxation is low or null, deferring the payment of the tax in the country of residence of its last beneficiary. Therefore, it is intended to discourage this maneuver by imputing the income

[41] Inc. 2 article 7 bis of title 7.

to the individual, without changing its nature, when the participating entity receives it.

In order to apply international fiscal transparency there are two important conditions: the NR entity must be a BONT entity, and the type of income received by that entity must necessarily be a passive income from abroad. For example, if a BONT entity has a business activity abroad, the TFI does not apply because although it is a BONT entity it is not a movable yield. However, if that BONT entity distributes dividends, it is a hypothesis of a NR distributing a movable yields that will be taxed on the individual, without the need to apply fiscal transparency.

The individual will effectively receive that money when the BONT entity decides to distribute dividends. Since this income has already been recorded before distribution, the standard exonerates these dividends, thus avoiding a double economic and legal imposition.

The imputation rule is also applicable when the NR entities participate in other NR entities that are subject to the BONT regime, and implies recognizing the income of the individual resident at the time when it is received by the first one of those entities.

Depending on the type of income the BONT entity receives, the distribution of dividends may be exempted or taxed, so it is necessary to establish an order of imputation. Resolution 662/007, establishes three brackets. First the income that were submitted to the system of imputation of NR entities will be imputed, that is, the yields of foreign capital that already were taxed on behalf of the individual and that when being distributed they are exonerated. The second step corresponds to the income of Uruguayan source, which is already taxed with IRNR on behalf of the NR entity, which are exonerated when distributed. The last bracket corresponds to the rest of the revenues obtained by the NR and which were not the object of imputation, for example business income abroad. In this case, the distributed dividends exceeding the sum of the first two brackets will be taxed at 12%.

The tax resulting from this system of imputation will be withheld if the NR entity opted to appoint a natural or legal resident as representative before the DGI, who will be jointly responsible for the tax obligations of the entity represented.[42] The taxpayer of IRPF can give definitive character to the withholding, and in this case, these incomes will not be computed in the liquidation of the taxpayer, protecting his anonymity. The Decree establishes the withholding on occasion of the payment or when the funds of the NR entity become available.

Some considerations:

- The problem of the norm lies in the control of these taxpayers because of the difficulty of identifying the resident individual beneficiaries of the income, and to have certain knowledge of the moment in which the NR entity receives it, when they are disclosed to the physical person. This situation is further complicated by the interposition of multiple NR entities. There is a problem of access to information by the individual who owns the shares or social participations of the BONT entity. Here we refer to the analysis conducted in the case 2.2.1.2 on Uruguayan fiscal transparency.

- In relation to the order of imputation of the dividends distributed by the BONT entities, we note that it is inverse and can be considered more beneficial than the order of imputation envisaged for the taxpayers of IRAE, since it first absorbs what is taxed and what exceeds the net tax income taxed by said tax is exempted from the distribution.

2.2.2.3 Changes introduced by the TFI Act

The LTFI replaces article 7 bis of title 7, naming it "allocation of income from non-resident entities". In the case in which resident individuals participate in the capital of NR entities, the income obtained by these entities will be determined and allocated as dividends distributed to the concerned individuals in proportion of their participation in their assets, so the imputation is currently carried out in proportional form. Next, the range

[42] Art. 8 bis of title 7 and Lit. Article 39 (H) of Decree 148/007.

of revenues under allocation is increased, including capital gains and equity increases, as they are obtained from BONT entities. As for the accrual, the standard maintains the presumption currently established in the decree, referring to the time when they are received by the NR entity.

It thus arises that the modification consists in assigning to the taxpayer of income tax the totality of the capital yields and wealth increases obtained by the NR entity as dividends.[43] This means that there is no longer a tax transparency, through which the BONT entity is ignored. The revenues do not mutate their nature, but they are somehow requalified. There is a temporary transparency when such dividends are allocated to the individual when the BONT entity charges the capital incomes and assets increases.

The law establishes that for the qualification and calculation of the assigned income, the existing provisions in IRPF for this type of income must be applied.

Some considerations:

- It should be noted that the complexity of control and supervision of the income imputed to the individual is increased by these regulatory changes, since it requires greater availability of information about the foreign investments, goods and businesses owned by the resident individual.

- Here also, the tools that the automatic exchange of information will bring to the TA to identify balances and incomes of accounts of the resident individuals who receive income from foreign financial institutions are useful; and this coupled with the obligation to identify and inform the Central Bank of Uruguay about the final beneficiaries of some NR entities.

3. THE PROBLEM OF SUBCAPITALIZATION

The particularity of incomes from dividends is that in most cases, the income-generating entity is taxed by IRPF, and then, the shareholder supports on his own the income tax on occasion of the distribution of dividends. This is a particular case of “double taxation”, and an unwanted effect can be the induction of companies to be financed through debt rather than through their own capital. The abusive use of this practice is known as “Thin capitalization”.[44] In the international specialized literature, a society is considered under-capitalized when the capital it owns is relatively small in relation to its liabilities.

When shareholders evaluate to finance companies by integrating capital or through a loan, the tax economies that affect that decision are determined from the tax burden that falls on the whole of the company and the shareholders. Normally there is a preference to formalize the investment as loans, which in general, without prejudice to other fiscal and extra-fiscal reasons, responds to the differential treatment that the interests and the dividends receive in the field of IRPF. This “deviation” from the forms of financing of companies towards those that mean a lower tax burden has merited consideration of the tax legislation compared to the mechanisms of retransmission of the loans and interests towards the tax treatment of the own capital and the dividends. In other words, sub-capitalization as a tax phenomenon is nothing more than a hypothesis of requalification, specifically applicable to loans and interests that are intended, for tax purposes, to relocate as capital and dividends.

In Uruguay, in coherence with the corporate legal norms, without prejudice to the specific regulations that limit or disadvantage in the tax scope the financing by means of loans, the tax legislation in general grants freedom for the financing of companies through capital or loans.

[43] By way of example, a Uruguayan natural person, shareholder of a BONT entity owning a property abroad which is leased, previously perceived lease income that were not reached by taxes in Uruguay. From the modification of the standard, this natural person must impute as dividends the income received by said lease, paying income tax at the rate of 12%. Likewise, when the property is sold it will also pay income tax, being that with the previous regulation was not reached.

[44] Romano, A., Cirimello, G., Vázquez, V., Acosta, J.A., Nieves, G., Camejo, C., Sonderegger, J., Calleja, A.L., Bruzzone, L. and Yori, M. (2013). Impuesto a las rentas de las actividades económicas (IRAE). Montevideo: La Ley Uruguay; Capítulo 1.

In the structure of the income taxation before the tax reform, the shortage of standards that specifically considered sub-capitalization was consistent with the freedom that the legislator devoted to the financing of companies, as well as the absence of compulsory relationship capital-liabilities in the assets of the companies. Additionally, the non-existence of a general tax on global income explained this also: to the extent that the IRIC only taxed, in principle, the income from the combination of capital and work, from the point of view of the beneficiary the interests were excluded from the fact generator of the tax. Moreover, in most cases the dividends' beneficiaries were not taxed.[45] In this context, the advantages of substituting own capital with loans from shareholders were neutralized by the inflation adjustment and the interest deduction caps. In addition to other reasons linked to the legal economic context, such as the existence of the banking secrecy and the use of companies with bearer shares, which enabled the existence of financing mechanisms without that the TA could establish their linkages.[46]

On the other hand, since the tax reform (LRT) the existence of specific rules to avoid the sub-capitalization is justified, since the structure of taxation to the current income implies risks of decrease of the tax revenues derived from the substitution of the own capital by loans. Here are, in our opinion, the critical points in this aspect:

- Although the current tax system provides autonomy between the different taxes levied on income (IRAE, IRPF, and IRNR), it was designed taking into account the quest for a systemic vision. An example of this is the integration of the taxation of the profits of the companies and the dividend income tax of the shareholder in order to avoid or attenuate the double economic taxation.[47] However, if the shareholder is not a taxpayer of IRAE, the double taxation is explicitly enshrined, since it does not apply any method to avoid or mitigate it (except in the case of NR shareholders before the eventual existence of a DTC).[48]

- In this new context, Uruguay has been progressing towards tax transparency, for which, among other measures, it relaxed the conditions of lifting the bank secrecy and the identification of the bearer shares and nominative shareholders became obligatory. In addition, the burdensome effects that implies for the shareholders the introduction of the new system of presumptive dividends are worth mentioning.

- Thus, in the case of the companies that pay, taxed dividends and the shareholders are taxable subjects of the IRPF or IRNR[49], under the assumption that they obtain a positive tax result; the total tax burden is lower if they are financed with loans than with contributions of capital. This is because from the investor's point of view, the interests are taxed at the rate of 12% and the dividends at the rate of 7% or 12%. Nevertheless, from the point of view of the company in its liquidation of the IRAE the interests are deductible expenses, although subject to the rule of the proportion of expenses depending on whether the counterpart taxes IRPF, IRNR or IRAE. This deductibility is not admitted for dividends.

- In the case of NR shareholders, it is necessary to take into account that in the scope of the IRAE the operations between PE and Headquarters (CM in Spanish) are considered as if they were carried out between parties that are juridical and economically independent, if their benefits and conditions are conform to the normal market practices between independent entities. However, as an exception to the principle of separate entities, in the article enumerating the unsupported deductions, the law established that financial transactions between the PE of NR entities and said entity should be treated as capital oper ations, between the CM Resident and their PE abroad, and between PE of the same CM located in national territory and abroad. These financial transactions will

[45] Blanco, A., y García, D. (1996). Aspectos fiscales de la subcapitalización. Revista Tributaria Nº 135, Montevideo, Uruguay, p. 611-628.

[46] Eibe, D. (1998). Situación fiscal de la subcapitalización. Revista Tributaria Nº 144, Montevideo, Uruguay, p. 397-411.

[47] In the case that the shareholder is a taxpayer of IRAE. It is avoided by the method of the exemption. For the profits obtained by districts entities that attribute revenue it is eliminated because the income is taxed exclusively in the head of the entity member.

[48] Romano, et al., op cit, 2013, capítulo 1.

[49] If the shareholder is a taxable person of IRNR and there is no DTC.

not be subject to generate tax results similar to any operation carried out between independent parties. Therefore, if the CM makes a loan to a PE located in Uruguay and the PE pays interest, since this operation has no fiscal effect, this can transfer utilities abroad in the form of interest, without withholding the corresponding IRNR. In this way, tax on dividends could easily be violated, by covering them as interest.

- In the case of operations between CM and EP, which are not of a financial nature or constitute contributions or withdrawals of capital, the transfer pricing rules apply; the eventual adjustments arising from that methodology have consequences exclusively in the scope of IRAE, therefore, without effects on the IRNR.[50] However, at the level of comparative law in some countries, it is understood that any payment exceeding the "arm´s length" price must be reclassified as a profit ("secondary adjustment"). This implies applying to that adjustment the withholdings corresponding to the transfer of profits to NR[51]. In our country, this adjustment does not apply.

As for the general rules, it should be taken into account that our country understands the concept of economic reality in article 6 of the tax code, according to which in the interpretation of the tax-generating fact the forms can never prevail over the substance. However, while this provision would make it possible to correct the abuses that might be made in terms of lending and interest payments, we should not forget the following considerations. 1) that this principle involves a comprehensive consideration of the situation analyzed and not only in terms of comparison with a business between independent parties; and 2) that the application of the standard should be made prudently and by evaluating in each case the elements of judgement, in such a way as to serve as corrective to the real abuses, but avoiding to infringe the freedom to finance companies through capital or through loans that exists for legal corporate and tax effects.[52]

[50] As already mentioned, the transfer or credit of profits made by the PE located in Uruguay to its CM located abroad is taxed by IRNR, if these profits originate in revenues taxed by IRAE.

[51] Romano, A. (2010). Tratamiento tributario aplicable a las operaciones entre casa matriz y establecimiento permanente. Cómputo de resultados entre establecimiento permanente y casa matriz. Trabajo presentado en las III Jornadas Tributarias, Montevideo, Uruguay.

[52] Blanco y García, o cit.

4. CONCLUSIONS

As expressed in the introduction of this work, we based the choice of the topic on the quest for an improvement in relation to the following aspects:

- The low collection on dividends paid by local companies and the recent implementation of a presumptive dividends system.

- The complexity in the control of the foreign utilities and the existence of more and more taxpayers that operate globally.

Based on the analysis developed in Chapter 2, regarding the dividends paid by the taxpayers of IRAE generated in rents taxed by said tax (point 2.1), we can conclude that the process of determining the dividends taxed and the payment of IRPF or IRNR is very complex. It is difficult to carry out for the taxpayers, difficult to control by the shareholders and difficult to be examined by the TA. The wide variety of possible situations in the companies (according to their taxation, accounting and fiscal profitability, amount and exercises in which they are distributed), requires the analysis of each particular case. Shareholders who are subject to withholding, as well as the TA, may find cumbersome to control the amounts withheld. They will need to control the accounting results, the statement of IRAE of the company that distributes the results and eventually from other companies that would have distributed them dividends, which is more difficult in the event that successive companies participate in the capital of other PS of IRAE. That is why we believe it is advisable to think of a more simplified system, at least for those smaller taxpayers, which would allow determining the tax in an abbreviated way and fundamentally to maximize the cost/benefit ratio of their control.

As for the presumptive dividend system, although in the initial stage can it implies certain practical difficulties for taxpayers, as a counterpart, perhaps in this way it is possible to collect more tax for the presumptive distribution than what is being currently collected for the real dividends. In any case, we will have to wait for the results to be measured.

Moreover, while a thorough analysis escapes the scope of this work, we understand that it is necessary to end unjustified exemptions, close legal loopholes and establish new specifications with a view to contributing to the improvement of collection and to the tax equity.

On the other hand, in relation to the dividends originated in capital performance from abroad (point 2.2), any action that aims to fight tax evasion and avoidance is more than advisable, with a view to not impair the collection power of TAs for the design of complex transnational operations as a result of the phenomenon of globalization.

In this sense, our tax system has progressed by incorporating certain measures of imputation, allocation or requalification of income, with the aim of combating the erosion of the tax base, the deferred payment of the taxes and the transfer of profits to other jurisdictions with lesser tax burden. However, the rule is too ambitious and inaccurate. We need to adjust it, in order to provide a realistic approach to the TA, and which in turn grants legal certainty to taxpayers. As for the exchange of information, the regulation has undergone changes and is currently in a process of including many measures aimed at its improvement. While in our opinion this fact is extremely positive, it generates the uncertainty of how the implementation will be in practice and its usefulness for the TA. In addition, it is noteworthy that the TA should have sufficient resources (human, computer, etc.) to carry out the control of the tax using this tool. We consider, in turn, that the exchange of information is one additional requirement to apply effectively the system of allocation of passive income from abroad. However, we are faced with the paradoxical problem that our country applies these rules when there are BONT entities, which by definition, are in countries with whom Uruguay has not agreed to exchange information or if it has, they are not implemented, which makes the control more complex. We understand that the identification of the final beneficiary is useful to rectify this fact. We should add to this that the disincentive to the existence of this type of entities makes that the cases of allocation of income are limited considerably.

On the other hand, in relation to the problem of subcapitalization, the global trend aims to incorporate rules in order to prevent the erosion of the taxable base by the excessive deduction of interest. While we could consider that the principle of economic reality is a standard rule, it must be taken into account that this type of solution leads to the difficult burden of proof for the TA and to the lack of legal certainty for the taxpayer, showing in the need to establish precise and objective rules. For all the above and aiming to increase the collection, we consider advisable to legislate the sub-capitalization hypothesis in order to avoid possible situations of avoidance through the corporate tax planning.

Throughout this work we have tried to address a very current and complex issue on which, although Uruguayan legislation has progressed considerably, it is imperative to move forward in the analysis of other approaches that at some point can be used for the reflection.

The logical and desirable process would be that the simplification of the calculation, the fulfillment of the criteria of fairness and legal certainty to the taxpayer must be reflected in the improvement of the control for the TA and the incentive of voluntary compliance by taxpayers. That way, we believe that improving the tax treatment of dividends is beneficial for the society as a whole.

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DIGITAL TECHNOLOGIES IN THE TAX INDUSTRY: THE CASE OF VAT

Job **KAVOYA**

SYNOPSIS

This paper presents a case explaining how digital technologies can be applied in tax administrations to create new capabilities that are geared towards improving compliance, efficiency, and increased revenues. The case specifically focuses on Value Added Tax and shows that digitization of this tax should begin with taxpayer recruitment and return processing. The paper relies on evidence from countries that have started the journey of digitization to build a case of digitization that can be applied in any tax administration. Its main contribution is that artificial intelligence can deliver positive results in terms of taxpayer-tax agency engagement.

CONTENT

1. Does long tail exist in the tax industry?
2. Empirical evidence
3. Digitizing VAT administration
4. Implications of digital technologies in VAT
5. Conclusion
6. Bibliography

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INTRODUCTION

Taxation is one of the oldest method used by governments to raise revenues to cater for public debts. Ancient history show records of taxes paid, Taxes in the ancient world (2002). However, Value Added Tax (VAT) is relatively new form of taxation introduced in the 20th century, Ebril, Keen, Bodin, and Summers (2001). In France, VAT was introduced in 1954 (Charlet and Owens 2010). Adoption of VAT across different countries was facilitated by different factors including trade agreements or trading blocs, and need for financial development assistance. Member countries in the European Union had to adopt VAT quickly since it was a prerequisite for members of the trading block while in other countries the adoption was driven by the support of International Monetary Fund (IMF), Charlet and Owens (2010). 160 countries in the world have implemented VAT and more countries are preparing to adopt VAT, Ministry of Finance Malaysia. The standard VAT rate charged in different countries vary from 1.5% to 27%, See Appendix 1. This relatively new tax has been argued to be the most effective tool that governments have at their exposure to generate revenues (Go, Kearney, Robinson, and Thierfelder 2005). VAT is computed ad valorem on select goods and some services. The tax bands for VAT vary and some countries have goods and services that are exempt from VAT, while others have a VAT rate of zero percent.

Administration of VAT can be classified into two different categories. First, VAT on imports is usually assessed, and collected by the customs during declaration and clearance of imported goods. The amount of VAT payable at importation is computed based on the customs value of the goods. Determination of customs value is based on the existing customs tax laws and procedures, but generally, includes a summation of price paid or payable on the goods, freight charges, marine insurance, and costs directly attributable to the goods. Secondly, VAT on goods sold within a country is assessed at the point of sale and VAT payable to the government is the difference between VAT on sales and VAT on purchases. To simplify VAT administration process, tax administrations have employed information technologies that range from registration of taxpayers, automation of VAT return process, and deployment of tax registers. Application of technology in business has resulted in numerous changes regarding how business conduct their affairs. These changes range from new production methods, new products, to new business models, and now to artificial intelligence.

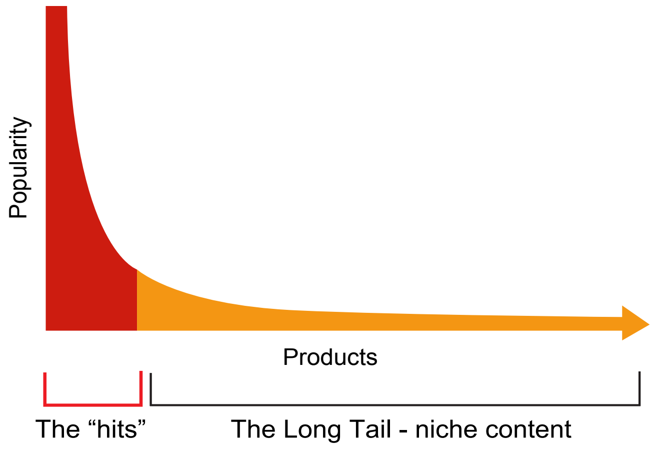
The technology world is changing at a faster rate than it was few years ago. Modern equipment are able to generate data, communicate with other equipment, act independently, and send and receive data that is analysed for another action. As a result, traditional businesses are constantly facing disruption. These disruptions cut across all aspects of business including operations, procurement, finance, human resource, marketing, and communication and reporting. Some of the notable disruptive technologies include Internet-of-things (IoT), cloud computing, advanced data analytics, and software-as-a-service (SaaS). The application of these technologies into business operations has led to improved efficiency, intelligence gathering, machine-to-machine data exchange, cost reduction, compliance management among others. Some businesses are adopting disruptive technologies as a strategy for competitive advantage. Take for example, IoT in the medical industry where patients get a wearable wristband that is able to capture data including patients sleep patterns, changes in body temperature, and blood pressure. This wearable device is able to collect patient data and send it autonomously to the hospital's patient management system. The band could also notify a patient when the body temperature has gone up beyond a set limit and notify the patient's doctor about the changes in the patient's body temperature. The data collected by this band will give a detailed view that was not previously possible to capture, providing the doctor with more information about the patient and probably lead to better diagnosis and treatment of diseases. Appelboom, Camacho, Abraham, Bruce, Dumont, Zacharia, D'Amico, Slomian, et.al. (2014). This example shows the potential new digital technologies can deliver on businesses by enabling new capabilities and allowing better understanding of problems. In the era of digital technologies, tax agencies have more options to create new solutions that improve compliance and increased revenues. Digital technologies are a major disruption to current businesses. To leverage technology for better service delivery, this case study shows how tax agencies can apply digital technologies in VAT administration.

In most developing countries, Small and medium enterprises (SME) contribute a lot to the economy growth and as such they are a great target for government revenues. SME's share of GDP compared to their payment of taxes is very low, Keen (2013). One question policy makers should ask is: how can the SME's be supported to continue contributing to economy growth as well as improve their compliance with tax laws? This case study argues that the solution lies in digital technologies. Some of the major technological disruptions stem from improved connectivity. The invention of 4G LTE (Fourth Generation Long-Term Evolution) network delivered increased connectivity and as a result, application of innovative and disruptive technologies in business operations is causing major changes in the traditional business models. Similarly, these technologies enable cooperation between businesses, which ultimately reduce costs, and risks.

1. DOES LONG TAIL EXIST IN THE TAX INDUSTRY?

The long tail concept proposes a new business model where products that have less demand can be as lucrative as highly demanded products. Anderson (2006) first suggested long tail concept in 2004. For these low demand products to be lucrative, Anderson (2006) suggested that there has to be a platform that supports many niche products making them readily available to buyers. The long tail concept postulates that hit products (high demand products) do not stay as hits for very long. Some products never become "hits" from the time they go to markets. Since consumer tastes and needs are varied, some will want to buy hit products while others prefer non-hit products. The hit products move from the top as soon as newer products come to market. This leaves very few products as hit and many products go to the non-hit section. This section often becomes the long tail.

Figure 1:
Long tail diagram



Source: www.longtail.com/about.html

There are lessons that tax agencies can learn from the long tail concept and customize them to tax administration. These lessons offer great opportunities and insights for tax agencies to align their operations to business environment thereby achieving revenue growth, improved compliance, and promote fair and legitimate trade practices.

Tax agencies usually trade-off the cost of doing an audit and the expected returns after the audit. This principle makes sense in that if a business invests $100 the returns should be more than the initial investment. With limited resources, tax agencies have few options: to focus on high tier medium and large corporations. In the long tail concept, these two groups (medium and large corporations) will be the hit products. They are fewer compared to small businesses, they handle huge transactions, and since they maintain detailed reporting systems, they are easier to audit. One oversight from this group would lead to high returns for the audit team. On the other hand, small and medium businesses has the largest user based and rarely are audited by tax agencies. This is due to resources limitation, lack of transaction supporting documents, and the large number in this category. This challenge presents a big opportunity for data analytics. *Gartner (2016) defines advanced analytics as the autonomous and semi-autonomous examination of data or content using techniques and tools, to discover insights, make* *predictions or generate recommendations.* Adoption of IT based technologies go a long way in managing costs and improving efficiency. In the long tail concept, the non-hit products are put in a platform that minimizes search costs and makes it easy for buyer and seller to connect. This platform acts as an ecosystem connecting a number of interested parties in one location. Looking at the tax administrations, most of their systems are not ecosystems but a solution centred on the needs of the tax agency. An ecosystem offers benefits to all the parties creating cooperation as well as competition.

Tax agencies desire to bring SMEs into the tax bracket must be done in a way that does not shrink their contribution to the economy, minimizes cost of compliance, promotes traceability of transactions, relies on data that is available on real-time to the tax agencies, and incorporates third party information as a support for non-traceable transactions. This case study argues that audit of SMEs can be done without requirement of any hardcopy files being submitted to the tax agency. This will be possible where digital technologies are incorporated in tax administration and data from SMEs is collected in real-time, collated and analysed for tax purposes. With 4G LTE penetration increasing in most parts of the world, connectivity will increase and this will set stage for more disruptions and opportunities. Tax administrations have greater role to digitize tax administration process.

2. EMPIRICAL EVIDENCE

This section presents a brief review of evidence to support the claim that traceability of transactions act as a good deterrence against tax evasions as well as investment in digital technologies by tax agencies will deliver positive results.

2.1 Tax transactions traceability and compliance

The underlying principle in this section is that audit requires examination of documents to determine the truthfulness of the entries as declared in financial statements. In the practise of audit, availability of supporting documents forms the basis on which an auditor gives opinion regarding the statements. In the tax audit, availability of supporting documents forms basis upon which tax assessment is done. Unavailability of transactions supporting documents in tax audit can be frustrating, and often can lead to unfair assessment of taxes payable. Documents aid in establishing traceability of goods from one firm to another. In the case of Chilean tax agency (Pomeranz 2015), it was found that firms that had their transactions traceable were more compliant as compared to those whose transactions were not traceable. This indicates that traceability of transactions is a strong deterrence to tax evasion. The Chilean findings indicate that there was low compliance levels among firms that sold to final consumers. These probably small businesses do not keep records and as such they may not declare any returns. In Denmark, Kleven and Waseem (2012) show that when the probability of detection of evasion is low, taxpayers engage more in tax evasion. Following Kleven and Waseem (2012), this case study argues that where detection and enforcement are low, tax evasion extends beyond SMEs to all sizes of taxpayers including large corporations. Tax agencies should work on increasing possibility of audit and audit should be move from the traditional aspects of examining manual statements that takes long time to using digital technologies that can act independently to analyse data, generate insights and trends. Digital technologies should lead to shorter period of audits. Audit data should include both real-time data from taxpayers as well as data from third parties.

Transactions traceability can benefit a lot with availability of third-party information. In the case of Ecuador, Carrillo, Castro, and Scartascini (2016) show that third-party reports declared a higher amount than self-reported amount. Carrillo et.al (2016) argue that in weak enforcement third party information will be less useful. With digital technologies, firms can easily receive third-party information and through analytics can identify trends that will uncover fraud and tax evasion. This evidence shows that improved traceability should act as a deterrence against tax evasion and that enforcement should be strengthened to increase compliance with tax laws.

2.2 Digitization of tax administration

The relationship between a tax agency and taxpayers is shaped by the technology that exists in the operating environment. Tax agencies are facing one big challenge:

the threat of shrinking revenues, and therefore, they have to move to digital technologies, which enables real-time collection and assessment of data, Ernst & Young consulting (2016). Access to data in real time forms a basis for quick response to compliance risks (Ernst & Young consulting, 2016) and overall, with this deterrence the compliance levels will increase.

The digitization journey is continuous and tax agencies should implement long-term goals aimed at a completely transformed organization. In Brazil, the tax digitization is ongoing and delivers a good reference for this case study. The tax digitization journey in Brazil began with establishment of the public digital bookkeeping system (SPED) [*Sistema Público de Escrituracao Digital*] (Silva, Passos, Gallo, Peters, 2013) which ensured that companies selling goods had to send invoice electronically to the government, Ernst & Young consulting (2016). Brazil has also implemented E-filing where both accounting and tax records are required, automated information exchange, e-invoicing, data analytics, and e-social where companies file electronic books and payroll information, Ernst & Young consulting (2016). The results of digitization efforts in Brazil are encouraging. The value of audit rose from R$ 6.2 in 2012 to R$ 9 million in 2013 and average increase in federal annual taxes has been 12.46%, Ernst & Young consulting (2016).

New technologies have continued to be developed which have the potential of revolutionizing the VAT tax assessment. One key technology is block chain technology. Ainsworth (2017) argues that block chain will deliver substantial efficiencies to VAT tax administration. In the blockchain technology, transactions are verified by the network nodes, and recorded in a public distributed ledger, Ainsworth (2017). This technology will be of great help to facilitate traceability of transactions from one company to another. This brief evidence shows that the expected changes in tax administration are huge if tax agencies move to digital technologies.

3. DIGITIZING VAT ADMINISTRATION

Digital technologies have caused major disruptions in business operations and tax administrations have to align their operations to the digital economy. There are opportunities for tax departments to develop and deploy digital solutions that will result in increase in taxpayer base, improved compliance levels, intelligence-based targeting and audit, reduced cost of tax assessment, and increase in tax collections. This section will discuss digital technologies that tax authorities can adopt to digitize tax administration. This case study argues that taxpayer recruitment and tax return processes are the primary candidates for digital transformation. This is because these two processes provide key data that is useful in VAT administration.

3.1 Taxpayer recruitment

Tax administrations have a section that deals with recruitment of new taxpayers into the tax bracket. Officers in this section will schedule visits to specific regions where they will physically enter into an office block and check whether a business has registration certificate from the tax agency. Businesses without tax registration certificate will be required to register. Some of the businesses are small and medium enterprises (SME) and recruiting them is both challenging and a lot of work. The tax agency requires massive resources to keep visiting the regions periodically to monitor which taxpayers are not registered with the tax agency. Digital technologies can be applied in taxpayer recruitment to simplify and standardize taxpayer registration and monitoring can be done remotely from the office.

Tax agencies can develop a solution incorporating maps application program interface (API) that will enable tax officers to view a region of interest in a map that includes all facilities. The facilities (buildings) owner will submit an approved building plan to the tax agency showing the number of floors in a facility, number of spaces to let per floor, and details of current tenants. The solution should allow the facility owner to update the tax system with details of the new tenants, or tenants leaving the facility. The tenant's details submitted will include tenant Taxpayer identification number (TIN), lease fees, and any other costs paid to the property owner by the tenant. The tenant will verify information submitted to tax agency once they access the tax agency system using their TIN. At the tax agency office, tax officers should be able to view in map buildings in a region/ area and query buildings to see how many of the spaces are vacant and those already occupied. Each office space will be uniquely identifiable and no tenant rents the facility without the property owner submitting their details to the tax agency. Registered taxpayers will receive a smart device (Smart Tax Register) that can transmit a signal to the tax office to show that the office space is occupied by a registered taxpayer. The device can be configured to show when the taxpayer is operating and when they are closed for business. Tax officers will periodically do physical inspection of buildings to verify occupancy.

Implementing this solution will have a number of benefits. First, taxpayer registration will be automated enabling new tenants to automatically become recruited into the tax base when they sign a lease with the facility owner. Existing tenants' data will be captured once in the system and thus all tenants operating within an area becomes active taxpayers. This will result into increase in taxpayer base. Secondly, for tax agencies that collect rental income tax, this solution will result into additional tax revenues. The rental revenues received by the property owner will be easy to determine and any allowable deductions can be determined assuming there is interface between third party and tax administration solution. Thirdly, this solution creates a level playing ground where all businesses operating within the tax jurisdiction become active taxpayers.

3.2 Tax Returns

Taxes are remitted to tax agencies to comply with existing legal framework and filing of tax returns is aimed at providing relevant information that enables monitoring of tax liabilities, Kopczuk and Slemrod, (2006). Tax returns is one of the pain points many taxpayers have to face in many tax jurisdictions. This happens because some of the tax laws are not clearly understood by taxpayers, fear of tax penalties and non-compliance, and complex process for filing the returns. In some instances, taxpayers never get to see the benefits of their taxes and therefore the need to file returns. Some taxpayers will want to verify whether the tax deducted monthly by their employers is actually remitted to the tax agency. In tax jurisdictions where tax returns are done using manual forms, the tax officers are faced with a new challenge of receiving the forms, sorting and capturing the tax data in the tax management system. The pain of tax returns affects both the tax agency and taxpayers, putting pressure on the agency's resources. Application of modern technology should eliminate the pain of tax returns filing by simplifying and standardizing the procedure as well as providing taxpayers with more information that will empower them to improve their compliance levels. This section explains the opportunities available for tax agencies to deal with the tax returns.

Tax returns can be classified into two main categories: individual tax returns and business tax returns. Individual tax returns includes employees Pay as you earn (PAYE), sole proprietor businesses, partnership business, and similar activities undertaken by an individual. Business tax returns include returns on corporation tax. In order to leverage digital technologies in modernizing tax returns, this case study suggests deployment of a smart tax register (STR). This tax register should have, in addition to tax register capabilities, cloud storage capabilities, 4G LTE connectivity or higher, ability to send and receive data autonomously, and ability to locate the position of the device remotely (location-enabled). Could storage capability will ensure connections between the tax servers and independent STR is optimal. 4G LTE connection will enable faster exchange of data between the STR and cloud servers. The STR will collect data and send it to cloud where analytics will be done and notifications from the tax agency could as well be communicated through the STR. Location detection will enable the tax officers remotely view where devices are located as well as when the devices are not in use. This smart tax register (STR) should replace existing tax registers.

In digitizing the value added tax (VAT) returns, this case study suggests a shared ledger format where the system is able to trace movement of products from one trader to another until the end consumer. Ability to trace transactions is a fundamental requirement for imposition of tax, Pomeranz (2015). Enforcement of tax is a very complex issue in developing countries. This limited availability of information issue is aggravated by lack of traceability of transactions (Pomeranz 2015) and this challenge leads to differences in tax systems between developed and developing countries, Kopzcuk and Slemrod, (2006).

In any tax jurisdiction, there are three main starting points for any products. First is farm produce that originates from local farmers. When a farmer has harvested his produce and sells it to a supermarket, a tax invoice should accompany the purchase and this acts as the starting point to trace the movement of the product. The second source is imports. Customs handles the imports of goods and most of the transactions can be traced from the customs system. Lastly, the local manufacturers are the third source of products consumed in a tax jurisdiction. For efficient digitization of VAT on goods, the tax agencies focus should be on these three originators of goods. When a manufacturer has manufactured goods and sold to firm A, the STR at the manufacturer premises will send the details of the transaction to the STR of buyer A via the cloud connectivity. When firm A receives the stock, STR at A is updated with stocks received and input VAT. When firm A sells goods to smaller retailers B and C, the STR will record the sales, output VAT, and determine the VAT due. This information will be send to the tax agency to show the expected receivable from firm A as well as all other firms.

It is a common practice for retailers to re-classify goods that should attract VAT as though they are zero-rated, reducing the amount of VAT tax payable. This tax offence will be dealt with in this solution. The three primary originators of goods are fewer compared to the many small retailers spread across the tax jurisdiction. If the tax agency focuses on ensuring the originators of goods classify the goods correctly for VAT purposes and that retailers are not allowed to re-classify goods, then there will be no revenue leakage on VAT. This reduction in number of entities that the tax agencies should focus on is in line with Kopczuk and Slemrod (2006). Imported goods are managed by customs and there is high probability that most of the goods will be correctly classified. This will require that as products moves from one firm to another they maintain a unique identifiable code to enable tracing and ensure no re-classification is done. Similarly, taxpayers who are not familiar with which products attract VAT will not need worry anymore. The STR will identify products that have been sold at a specific shop and cannot be traced back. Similarly, the STR will be able to track quantities to ensure that quantities declared at importation match the quantities sold, but this should be implemented on specific products.

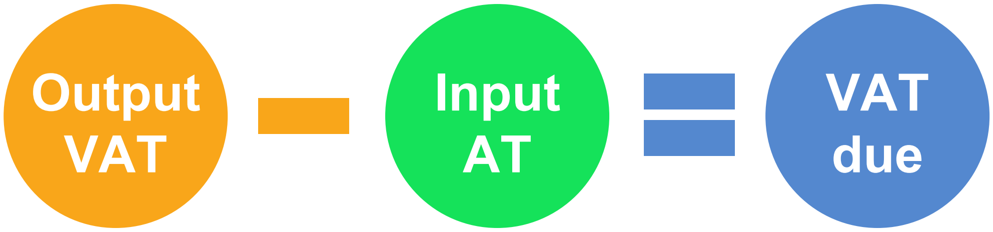
Application of artificial intelligence on different industries is on the rise and tax agencies should not be left behind on this area. The STR should become part of artificial intelligence in the tax industry. STR can be configured to send reminders to taxpayers about due date for VAT return or it could act as a tool to educate taxpayer about tax matters. A taxpayer may want to understand what the tax law says about tax invoices. Think of a situation where the taxpayer asks the STR which section of the law deals with tax invoices and the STR responds immediately. Or suppose there is a new legislation that affects the operation of the VAT. Similarly, a taxpayer can be reminded by the STR on deadlines for filing returns immediately they report to office through an audio. Incorporating text to speech capabilities in the STR will ensure that the STR can convert a text notification to an audio and play it to the taxpayer. Tax agencies can use the STR to communicate detailed information regarding the new legislation in different formats including digital audio recordings, video or animation. It saves taxpayers time, ensures direct communication with taxpayers, and it can be used to evaluate the effectiveness of the different methods used be the agency to communicate to taxpayers. This case study argues that digitization of taxpayer recruitment and return processing will revolutionize VAT administration. It also proposes development of artificial intelligence that will be create a new avenue for engagement between tax agency and taxpayers.

3.3 Why VAT

VAT is charged either at clearance of imports or at point of sale by local businesses. This puts VAT at the middle of a number of other taxes assessed by tax agencies. For imports, VAT is assessed and collected by customs and this acts as one source of data to trace movement of goods from one firm to another. In the local businesses, VAT is charged on sales (revenues). The sales revenue becomes the basis upon which firms generate profit and are able to finance their operations. From the sales, VAT is payable and other taxes including corporation tax are computed from the basis of sales. This scenario shows that there is a link between imports, sales, and taxes. In a situation where all local transactions are digitized and traceable, VAT becomes the most critical tax to focus on. This case highlights three reasons as to why VAT digitization is so critical for digital transformation of tax administrations. First, data from VAT provides insights and intelligence to customs. Secondly, digitization of VAT eliminates the need for excise good management solutions, and finally high frequency of VAT returns filing increases probability to detect fraud and evasion.

VAT data can be a very resourceful input in customs compliance and audit functions. VAT covers all purchase and sales transaction leading to input VAT and output VAT respectively. The difference between output VAT and input VAT gives VAT due.

Figure 2:
Computation of VAT due



VAT due at imports clearance is computed differently. At the clearance of imports, the importer makes a customs declaration that includes goods description and quantities imported. Imported goods are identified using the Harmonized Commodity Description and Coding System (HS). In facilitating international trade, customs departments have continued to employ different techniques including non-intrusive cargo inspection, intelligence gathering and sharing, and other intelligence-based examination of cargo. However, these techniques do not ensure that all goods are correctly declared. With limited resources and huge volume of cargo, manual examination of cargo is not possible. To increase compliance, VAT data should provide insights in relation to imported finished goods are raw materials.

Imported goods (finished goods or raw materials) are consumed locally or re-exported to another country. Re-exports falls under customs, providing a clear link to trace the goods movement. Local consumption is through businesses that sell to other businesses or to final consumers. These local businesses charge VAT on sales and this data can be traced back to imports. Using the STR, the sales data will be available real-time to the tax agency. With analytics, the sales data can be mapped with the import data. This will enable customs identify some of the products that local businesses are selling but the import data is missing. Similarly, the data could show differences between quantities declared in import declaration and quantities in sales data. These insights will be useful for customs to understand which goods are under declared or misdeclared by importers. Customs could as well identify the source of the goods (transactions traceability) and therefore initiate intelligence-based audit. VAT digitization will uncover tax fraud and evasion in customs, provide insights and intelligence, and ultimately ensure higher compliance.

Operationalizing this function requires a unique identifier of goods in the local businesses. The point of sale machines installed in businesses should be re-designed to ensure goods have unique identifier as this will ensure traceability of goods from one business to another. This unique identifier should link customs and sales data such that through analytics insights and trends are identified and relayed to respective tax office. This will shorten time to discover fraud and evasion of taxes.

Tax administrations are working on solutions to manage excisable goods. Similar to VAT, excise duty is charged on imports as well as local transactions but on select products. This case argues that digitization of VAT will eliminate the need for excise goods management solutions. In a situation where all goods transacted have a unique identifier, it is possible to pull data for excisable goods and track their movements from one firm to another. The sales data generated under a digitalized VAT system will identify quantities of excisable goods, excise duty due, and firms within the supply chain. VAT digitization will enhance VAT administration, excise duty, provide data for customs audit and compliance as well as provide a basis for corporation taxes.

VAT returns have a higher frequency of filing. Most tax administration require VAT returns be done monthly, See Appendix 1. This high frequency of returns filing coupled with availability of third-party information could provide a good ground for tax administrations to uncover tax fraud and evasion. Empirical evidence shows that third party information had higher amounts compared to returns declaration, Carrillo, Castro, and Scartascini (2016). Digital technologies are creating new capabilities that enable faster exchange of data. Tax agencies taking advantage of third-party information coupled with high frequency of VAT returns filing can go a long way in discovery of tax malpractices.

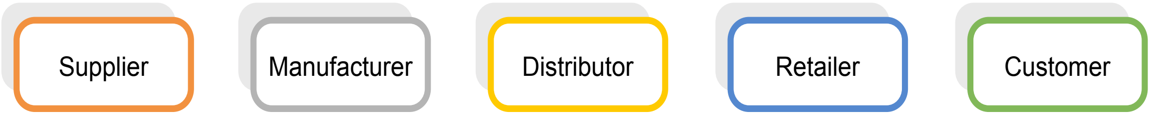
4. IMPLICATIONS OF DIGITAL TECHNOLOGIES IN VAT

This case shows the opportunities available to tax agencies in different parts of the world to revolutionize and improve efficiency in tax administration. These opportunities stem from digital technologies. Digitization of VAT is recommended as a key focus area that can change the whole tax administration, and not just VAT only. In this section, the focus is to understand how digital technologies are affecting VAT amount collection and build a justification as to why digitization can close the VAT deficit occurring due to digital technologies in the business environment. The first part the case focuses on supply chain changes because of digital technologies in the business environment and second part examines how these changes affect VAT collection.

4.1 Supply chain changes

Supply chain has been defined as all activities associated with transformation of raw material to final product and delivery to the final consumer, Handfield and Nicholas (1999), Lummus and Vokurka (1999). In a simplified format, the traditional supply chain was as shown below:

Figure 3:
Traditional supply chain



As growth of new technologies continue to shape business operations, new business models creating new value and enabling new capabilities that never existed before have come to life. One of the key changes in the supply chain is reduction of the intermediaries that existed in the traditional supply chain. The “Amazon effect” is a term that is increasingly being used in today’s business to mean the changes that digital technologies have on the traditional supply chain. Some intermediaries have been pushed out of business, staff have lost their jobs, some firms have reduced the number of their physical offices, and the changes are still increasing. All these changes affect government revenue in different ways. In this case, the focus will be on VAT.

The adoption of digital technologies in business has led to reduction of intermediaries in the supply chain. VAT is charged on value added in the supply chain. Reduction of intermediaries means customers can get products at a relatively lower price but a reduction on VAT. To demonstrate this reduction in VAT, this case assumes a VAT rate of 10%, price mark-up of 20%, production input VAT of $9, and manufacturer selling price of $120. With the traditional supply chain process, the flow of goods from manufacturer to end consumer for VAT computation will be as show in the table 1 below:

Table 1:
VAT Computation

	Purchase Price	Selling Price	Input VAT	Output VAT	VAT Due
Manufacturer	---	120	9	10.90	1.9
Distributor	120	144	10.90	13.09	2.19
Retailer	144	172.8	13.09	15.71	2.62
Customer	172.8	---			
Total VAT					**6,71**

Source: Author demonstration

In the traditional supply chain, the total VAT due from the same product will be $6.71 if it moves through two intermediaries as shown in table 1. The more the intermediaries, the higher the VAT amount due. However, with digital technologies the manufacturer can sell the product directly to the consumer and charge a price less than the price charged in the traditional supply chain. If the manufacturer sells the product at the same price retailers would buy from a distributor ($144), the total VAT from the product reduces from $6.71 to $4.09. (Output VAT of $13.09 less input VAT of $9). Customers have access to information regarding available substitute products and this makes it hard for the manufacturer to sell the products at the same price a retailer would sell ($172.8). PWC (2017) shows that price is very critical in digital channel transactions. The number of monthly online shoppers in the Middle East rose to 29% and 40% of the respondents pointed to price as their motivation for online purchases, PWC (2017). The preference of digital channels over physical stores means consumers are very price sensitive with increasing access to information and ability to compare prices between different sites.

The supply chain is continuously changing. These changes are affecting VAT due as it shortens the value addition process. Tax agencies have to work on reducing the cost of VAT administration and improve efficiency of the process to achieve high level of compliance with VAT laws. Accenture (2016) explains that digital platforms have three distinct power; that is network effect, concurrence of technologies, and open and shared data. Accenture explains that these platforms not only do they generate revenue they also reduce costs. Tax agencies can learn a lot from the business platforms and develop solutions that bring different stakeholders together in an ecosystem that reduces costs, enables faster data sharing, and creates new value to all stakeholders. This ecosystem might close the revenue gap that has originated from changes in supply chain.

5. CONCLUSION

Digital technologies are creating new capabilities that were not possible before. Collection of information from taxpayer is now more simplified than ever before and storage costs of data have continued to fall. This case study has presented on overview of opportunities that tax agencies can adopt to increase their tax base, raise additional revenues, and simplify the process of tax filling. However, these benefits are not without challenges. The cost of the hardware, the development of artificial intelligence, cost of internet for small and micro-traders who are not ready to incur additional and unnecessary costs, training and support are some of the issues that are likely to occur during implementation of this program. Overall, tax agencies will be better off digitizing their operations and VAT should be the leading tax head to be digitized.

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APPENDIX

Country	STD. VAT	Period	Country	STD. VAT	Period
Albania	10	Monthly	China	17	Varied
Jersey	5	Monthly	Morocco	20	Monthly
Argentina	21	Monthly	Colombia	16	Bi-monthly*
Jordan	16	Bi-monthly	Myanmar	5	Quarterly
Armenia	20	Monthly	Costa Rica	13	Monthly
Kazakhstan	12	Quarterly	Namibia	15	Bi-monthly
Aruba	1.5	Monthly	Croatia	25	Monthly
Kenya	16	Monthly	Netherlands	21	Monthly*
Australia	10	Monthly	Curucao	6	Monthly*
Korea, South	10	Quarterly	New Zealand	15	Monthly*
Austria	18	Monthly	Cyprus	19	Quarterly
Kosovo	16	Monthly	Nicaragua	15	Monthly*
Azerbaijan	18	Monthly	Czech rep	21	Monthly*
Latvia	21	Monthly	Nigeria	5	Monthly
Bahamas	7.5	Monthly*	Denmark	25	Monthly*
Lebanon	10	Quarterly	Norway	25	
Barbados	7.5	Monthly*	Dominican Rep	18	Monthly
Lithuania	21	Monthly*	Pakistan	15-17	Monthly*
Belarus	20	Monthly*	Ecuador	12	Monthly
Luxembourg	17	Monthly*	Panama	7	Monthly
Belgium	21	Monthly*	Egypt	10	Monthly
Macedonia	18	Monthly*	Papua New Guinea	10	Monthly*
Bolivia	13	Monthly	El Salvador	13	Monthly
Madagascar	20	Monthly	Paraguay	10	Monthly
Bonaire, Sint			Estonia	20	Monthly
Eustatius &Saba	4~8	Monthly	Peru	18	Monthly
Malaysia	6	Monthly	Finland	24	Monthly*
Botswana	12	Monthly*	Philippines	12	Monthly
Malta	18	Quarterly	France	20	Monthly*
Brazil	0-35	Monthly	Poland	23	Monthly
Mauritius	15	Monthly*	Georgia	18	Monthly
Bulgaria	20	Monthly	Portugal	23	Monthly*
Mexico	16	Monthly	Germany	19	Monthly*
Canada	5	Monthly*	Puerto Rico	7	Monthly
Moldova	20	Monthly	Chana	15	Monthly
Chile	19	Monthly	Romania	24	Monthly
Mongolia	10	Monthly	Greece	23	Monthly

Country	STD. VAT	Period	Country	STD. VAT	Period
Russia	18	Quarterly	Spain	21	Monthly*
Guatemala	12	Monthly	Japan	8	Monthly
Rwanda	18	Monthly	Suriname	8	Monthly
Honduras	15	Monthly*	Sweden	25	Monthly
Saint Lucia	15	Monthly	Switzerland	8	Quarterly
Hungary	27	Monthly*	Taiwan	5	Bi-monthly
Serbia	20	Monthly	Tanzania	18	Monthly
Iceland	24	Bi-monthly	Thailand	7	Monthly
Seychelles	15	Monthly*	Trinidad and Tobago	15	Bi-monthly
India	12.5-15	Monthly*	Tunisia	18	Monthly
Singapore	7	Monthly*	Turkey	18	Monthly
Indonesia	10	Monthly Sint	Uganda	18	Monthly
Maarten	5	Monthly	Ukraine	20	Monthly
Ireland	23	Bi-monthly	United kingdom	20	Quarterly
Slovakia	20	Monthly	United States	2.9-7	
Isle of man	20	Monthly*	Uruguay	22	Monthly
Slovenia	22	Monthly	Venezuela	12	Monthly
Israel	18	Monthly*	Vietnam	10	Monthly
South Africa	14	Monthly*	Zambia	16	Monthly
Italy	22	Annual	Zimbabwe	15	Monthly

Source: EY 2015 Worldwide VAT, GST and sales tax Guide

* Means other return period may apply if certain conditions are fulfilled

TOPICS TO CONSIDER FOR THE **CONTROL OF THE INCOME TAX** IN THE MINING SECTOR

Fredy Richard
LLAQUE SÁNCHEZ

SYNOPSIS

This paper presents a review of the corporate income tax risks that can be faced regarding the management of medium and large companies in the mining sector. The document describes the transversal and specific risks that must be taken into account in both the *risk assessment* process and for *review purposes* during a tax audit. It offers management suggestions that can serve as a basis for the administration strategies regarding these risks, including clarifications in the legal framework that are necessary. The present work seeks to contribute to the process of understanding the mining activity by the tax administrations.

CONTENT

1. Some transversal risks of mining activities
2. What is required to define a control strategy in the mining sector?
3. The life cycle of a mining project
4. Risks of the mining sector with respect to the income tax
5. Conclusions
6. Bibliography

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INTRODUCTION

During the last two decades, the countries of Latin America and the Caribbean (henceforth LAC) have received strong investments in activities related to mining. This investment, mainly of foreign source, has promoted a significant growth in mineral exports, which have generated an increase in the taxes derived from this new level of activity and encouraged by higher international prices.

This bonanza situation was not maintained over time, and many tax administrations have been facing the fact that, contrary to expectations, the new level of operation and the higher price of mining products did not translate into higher *corporate income tax* (henceforth CIT) payments.

Furthermore, in some cases, it was observed that revenues of mining companies decreased significantly, sometimes because of the restructuring of operations caused by profit shifting.

The concern about the issue of income tax erosion in the mining sector becomes more important since currently, in a period of "low quotation" of the mineral prices, the decrease in collection from the mining affects significantly the countries' budgets. In many cases, the increase in collection from other activities does not compensate this decrease in collection and therefore generates the need to assume more debt.

While there are now important reasons for this reduction in revenue (the fall in the price of metals), we must not forget that the main risk about medium and large mining groups, from the perspective of tax administrations, are risks associated to the *veracity gap*.

1. SOME TRANSVERSAL RISKS OF THE MINING ACTIVITY

At the 2014 Conference in Brussels, CIAT[1] presented a paper on the mining activity among its member countries and its importance in terms of GDP and tax revenues. The paper also showed a summary of the problems that CIAT member countries had reported.

These problems, transversal to most countries, were related to difficulties, such as: valuation of natural resources, the rules of transfer pricing in terms of their application to extractive activity, the treatment of costs and expenditure on exploration and development, expenditure on social infrastructure. They also relate to the treatment of reserves and provisions, the transfer of interests, customs duties and preferential treatments with respect to VAT on imports, sub-capitalization, the treatment of hybrid financial instruments, the management commissions, among others.

The presentation by CIAT was intended to transfer the risks reported by the member countries and to show the problems faced by the tax administrations, risks that must be managed in order to reduce the negative impacts that they could generate.

2. WHAT IS REQUIRED TO DEFINE A CONTROL STRATEGY IN THE MINING SECTOR?

The way forward in order to achieve better control of the extractive activity, in general, should include the revision of the tax policy design in order to achieve an ad-hoc treatment and a robust legal framework. It should include anti-evasion rules (specific or general); an in-depth understanding of today's business conditions and the problems related to international taxation[2]; the development of capacities in the tax administration, including the optimization of their implicit and/or explicit control models.

[1] View presentation in the following link: http://www.taxcompact.net/activities-events/2014/EC-ITC-WB-Conference-Brussels_Sep.html, session 2

[2] The mitigation of these risks includes having robust transfer pricing rules and the possibility of making effective exchanges of information between tax administrations. The general recommendation to have in the legislation the possibility of signing Anticipated Pricing Agreements (APAs) completes the set of treatments that have been developed and that have been reported as useful mechanisms.

The foregoing without losing sight of the need to try to keep low (or as far as possible, to reduce) the administrative costs of tax enforcement and compliance costs, in order to prevent affecting the competitiveness of the country.

The development of capacity building in the tax administration should include developing (or mastering skills and knowledge) that allows performing operational audits to reduce the risks that incorrect practices may generate in the payment of taxes. It also requires access to reliable information on the prices agreed for transactions in international markets as a requirement to avoid reducing the tax base of the countries by using "improper adjustments".

Given the importance of the mining industry in the collection of many countries, addressing these challenges requires the development of a comprehensive compliance strategy consistent with the government's objectives. It should include all aspects related to the management of the sector, the identification of the units involved as well as their responsibilities and goals.

It is clear that the activity control exceeds the taxation framework and requires effective cooperation with other government agencies to exchange information, the adoption of a risk management framework to effectively control and provide the services needed by the taxpayers to comply correctly, the development of a mechanism for a faster and impartial dispute resolution. It also requires the development of control capacities of diverse types in the various public agencies involved.

The risk management of the activity requires the use of treatment instruments involving the participation and collaboration of many public actors and the development of an effective sectorial tax regulation coordinated and coherent, with optimized processes that generate low compliance costs.

By taking into consideration the above-mentioned elements, we can conclude that the development of an optimal control strategy exceeds an approach centered only on tax issues and on the Tax Administration's capacity.

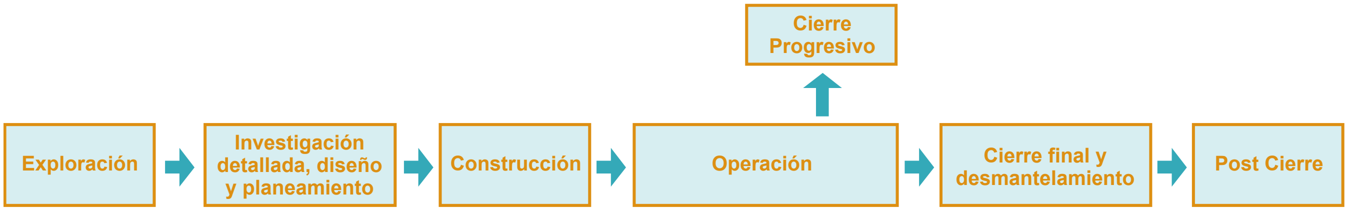
3. THE LIFE CYCLE OF A MINING PROJECT

The mining production process presupposes a sequence of stages that must be carried out before benefitting from the mineral resources. The different stages in the activity usually have a variable period of maturation. This period depends on the magnitude of the mining project, its location, the services available in the area of exploitation, the type of deposit and mineral to be exploited, the capital available, among other factors.

Regarding this plurality of stages, before starting to produce, these stages are mandatory that is to say, that one cannot advance to a next stage until having completed the previous one, without prejudice of the fact that all these stages are not always carried out and/or executed directly by the companies. The stages can be outlined, as proposed by SNMPE[3] (2015, 33) as follows:

[3] The National Society of Mining, Oil and Energy (Spanish name Sociedad Nacional de Mineria Petroleo y Energía, or SNMPE) is a non-profit organization that brings together the main mining companies operating in Peru. See: http://www.snmpe.org.pe/

Figure N° 1
Scheme of the life cycle of a mine and the phases of the closing plan


Cierre Progresivo
Exploración
Investigación detallada, diseño y planeamiento
Construcción
Operación
Cierre final y desmantelamiento
Post Cierre

Source: National Society of Mining, Oil and Energy

Each of these stages includes carrying out a series of operations with tax interest and among which we can identify risks that should be managed by the tax administrations.

4. RISKS OF THE MINING ACTIVITY WITH RESPECT TO THE INCOME TAX

In the following points, we will present a series of risks that are particular to the mining activity. We have not intended to present a complete inventory of all the risks.

We must remember that the process of identification of risks requires as a starting point a framework of reference established by the country where we carry out the identification of risks. In this case, for Peru, we must take into account the legal factors, the environment, the strengths and weaknesses of the public administration, among other elements, as detailed in the best practices of risk management.

4.1 Risks associated with exploration expenditures

Since there is usually a legislation providing early recognition benefits to such expenditure, the risks arising with respect to this issue are two: 1) To consider unduly capital disbursements as current expenditures in order to report losses and (2) to report a double deduction of the expenditure.

The second risk materializes when expenses that are capitalizable under tax laws are deducted as soon as they are incurred. This treatment differs from what is set out by the accounting rules (International Financial Reporting Standards – henceforth IFRS); in attention to these rules, these disbursements must be capitalized and amortized in the future.

This difference in time, given the long term of the project and if there is a deficient control, could be deducted more than once, the first time to take advantage of the favorable promotional treatment provided by the tax rules. The second time, as a correct financial amortization, which when not adjusted by the taxpayer and not detected by the administration, could generate a double deduction.

In order to avoid this, it is advisable that in the mining industry and due to its large maturation period, the expenses of this type should be reviewed before the deadlines for revision even if there is no short-term collection interest, and a good control of the *Deferred tax liabilities (IRD in Spanish)* is required.

Another important issue is that, at this stage, highly specialized services and goods are often used, whose market value reference is not always known. These goods and services are usually channelled to the project through related companies. This topic calls for a double attention, first to make sure that the good and service was actually used in the project, and then to make sure that the transaction prices follow the transfer pricing rules.

4.2 Risks associated with development and construction expenditures

Mining companies -as in many sectors- usually make disbursements that can be considered as *assets* or *expenses*. In the mining sector, in order to distinguish what concept we are facing and to distinguish between the two, the phases of the mining project are often taken into account; this makes somehow easier to identify which of these disbursements should be treated as assets and which must be treated as expenses.

It is at the stage of development and construction that the largest investments in fixed assets are made. To reach this stage, pre-feasibility and feasibility studies must have been completed and the optimal mining method must have been defined, that is to say, whether the exploitation will take place underground or in open pit mining.

A document that for the purposes of auditing could help us to distinguish between assets and expenses and to establish at what stage we find ourselves is the ***final engineering project*** that is usually accompanies the feasibility study.

The general recommendation is that we should keep an eye on the company's practices with regard to the treatment of disbursements at this stage. Sometimes these collide and/or have special treatments in each country regarding the general rules of CIT.

In general, the Peruvian mining companies, as stated in SNMPE (2015), usually consider as *intangible* the costs of development incurred before starting production, these costs are then amortized following the method of production units based on the proven and probable reserves (pp. 71-73).

Mining companies generally consider that the *development* costs relate to areas under exploitation, and which are consequently contributing to the current production of the mining unit, must affect the operational result and should not be activated.

To consider these disbursements as *cost* or *expense* is in some cases a decision of the accounting policy of each company. During the audit, the auditor in charge of the case should have this in mind because it could conflict with the accrual of these expenditures.

There are issues that require a more careful analysis such as the *disbursements related to the stripping* of the work area. The most accepted accounting practice is that the disbursements by this concept during the construction and development stage are considered part of the cost of the project and therefore capitalized and treated as an intangible, subject to amortization during the operating life of the mine.

This practice changes when the production stage starts[4], at this stage the cost of the stripping is considered as production cost, which is recorded as current expense or controlled as a deferred expense with a fixed impact within the production costs of the associated stage. To precipitate the expense by not following this practice for tax purposes, unless explicit acceptance by the tax standard, has a significant impact on the results of the project to be controlled.

Another issue to consider is the *development costs* of areas *different* from those currently in exploitation. The practice in this case is that the disbursements for these concepts are evaluated annually in order to determine if it is correct to keep capitalizing them. If it is decided that the area where these disbursements are made is not economically viable, the accumulated costs previously activated are charged in their entirety to the operational results. This is another point of focus during an audit because it can precipitate expenses that should have been deferred.

On the other hand, the *assets that are bought to build the project* are capitalized and their depreciation is activated as part of the costs of the project. In this case, when the project begins its production stage, the depreciation is recorded as part of the production cost.

Here the analysis of the costs eligible to be activated is critical, especially due to the high amounts associated with the mining, the engineering works, procurement, administration and construction-assembly works that

[4] It is considered in mining practice that a mine is in its "production phase" when the saleable mineral is extracted, and has already reached its "projected minimum production".

are associated to this stage must be carefully reviewed in order to avoid overvaluations. At this stage, it is essential to analyze the "allocated" expenses that are capitalized on the value of the assets that are being developed.

Finally, the *treatment of distribution of indirect costs* usually assumes that at the end of the construction stage, part of the indirect costs are assigned the areas or units that qualify as elements of property, plant or equipment (fixed asset in the Peruvian tax terminology). The assignment is made in attention to reasonable criteria. Remember that these indirect costs are usually assigned taking the direct costs as a reference.

With regard to the *costs of temporary constructions*[5], these are assumed by the project if they are only used for the construction stage and are demolished or removed later. However, if they will later be used in the project (as usually happens) they are capitalized and then their depreciation is recorded as part of the production cost. The same attention is needed if their withdrawal was initially anticipated, but subsequently it was decided to use them.

An additional issue is that referred to the *agreements of transfer of rights*. While development and construction costs are often very important, it is normal for taxpayers to sign agreements to involve other partners. These agreements are normally carried out through *agreements of transfer of rights*, by means of which the part incorporated into the project acquires a participation in the project, which can take as a reference fixed or variable expenses amounts and/or referents of capital.

During the life of the project, especially if it is an important project, several *agreements of transfer of rights* may be concluded, which must be reviewed. Agreements of transfer of rights may have more beneficial tax treatments, since depending on the definition of what is considered *capital gains*, situations could occur where these gains are not taxed.

On the other hand, the conditions of the agreement must be reviewed in order to establish whether the obligations assumed by the new partner of the project have been fulfilled. They must determine whether these expenses and/or investments, have been carried out effectively in order to give the right and admit – when applicable- the deduction of expenses and/or the amortization of the assets provided, and especially determine if they correspond to the mining project.

4.3 Risks associated with the treatment of disbursements related to the concession

SNMPE (2015, p. 45) defines the mining concession in the following terms:

> "It is the administrative act by which the State confers to a person or entity a real right for the exploration and exploitation of mineral resources within a granted land surface area and the property on mineral resources to be extracted in accordance with the provisions of the concession title"

In some countries, the mining concession constitutes a different right, i.e. separate and independent from the rights on the land where it is located. It is also common that rights on the superficies are not included.[6]

There are several contracts, by which the right of exploration/exploitation of a concession can be obtained, such as *Transfer contracts*[7], *Option contracts*[8], and *Mining Transfer contracts*[9], *Mortgage contracts*, among

[5] We refer to canteens, offices or dwellings

[6] In some countries, the natural resources are property of the owner the land where they are located, in other cases, as in the case of Peru (see article 66 of the Political Constitution) natural resources are considered national assets. The license is the mechanism that enables the beneficiary to operate and the act conferring the respective exploitation right.

[7] It is a typical contract from which the holder of the mining concession permanently transfers his ownership to a third party in exchange for a financial or in-kind consideration.

[8] SNMPE (2015, pp.) 45-46) consider that:
It is a typical preparatory contract, linked to a transfer or assignment; through these contracts, the holder of a concession can hold in the future contracts on concessions of which it is titular. Through the transfer option, the transferor gives the transferee the possibility of obtaining the ownership of the concession, in exchange for a consideration. As a reflection of this contract, the transferee acquires the possibility of acquiring the ownership of the mining activity by means of transfer. It is usually given the treatment of an intangible asset.

[9] SNMPE (2015, pp.) 45-46) consider that the contracts of transfer allow:
... the concessionaire – "assignor" – to transfer to a third party – "Assignee" – the temporary ownership of the mining concession, in return for which he receives a remuneration called compensation, which may consist of a sum of money, in a amount of ore extracted or benefited, or at a percentage of its value. This being produced, the assignee replaces the assignor in all his rights and obligations.

others, through which this right can be transferred temporally or permanently.

The type of contract and the general or specific legal framework will determine the accounting treatment given to the concession, and the tax effects referring to the cost and amortization could be derived from there.

The normal practice of mining is that *mining concessions* are classified as *intangible assets*, after which they are amortized based on the method of production units or under the straight-line method. The amortization of mining concessions starts from the production stage using the *production unit method* under the reference of *proven and probable reserves*. If the project is abandoned or if the expiration of the concession occurs, the associated costs must be recognized immediately in the income statement, the same policy must be followed if no exploitable mineral body is found.

In their initial recognition, the mining concessions are counted at the cost of acquisition, if the concession is considered an intangible asset this value is adjusted adding the cost of voluntary revaluations. Valuations should be carried out by independent experts taking into account the fair value at the date of appraisal minus their accumulated depreciation. The values attributed to the concession must be reviewed periodically, recognizing the changes in the net worth or the results of the period in case they exceed the assessed value.

These accounting practices may conflict with the tax rules of the different countries and are themselves a source of differences and possibilities of execution of tax planning, so they must be a matter to review in terms of their effects, according to the laws of the country.

The marketing and/or concessions rights contributions made directly and indirectly also generate tax planning options, generating increases in the value of the asset that later affect the production cost, if the profit on the asset commercialized and/or provided is made in a country of low or no taxation.

A mechanism used by companies, when the legislation of a country permits it, is to reframe a transaction of purchase of a mining concession as a payment for the transfer of a royalty contract.

This operation is done in order to make the purchaser deduct in a single exercise the price paid for the acquisition of a mining concession rather than in several periods according to the expected life of the project, as following its exploitation pattern.

Here again a robust legislation is seen as a more appropriate solution to an issue that is debatable. Although the administration can argue that in application of the principle of correlation between income and expenditure (which is usually implicit or explicit in the income tax legislation), the payments for this concept cannot be deducted in a single exercise. These must be amortized throughout the life of the project, and if the legislation does not help, this issue would be debatable.

4.4 Risks associated to revenues

In the mining industry, normally the product obtained from an exploitation is the *ore concentrate*, an intermediate product that can be marketed, obtained from various *metallurgical processes* to recover the greatest possible amount of metal content.

Concentrates are named taking into account the largest metal they contain; this is copper concentrate, lead concentrate, etc. The concentrates must pass through a process of smelting and refining in order to become metals and obtain the degree of purity of 99.99%, which is the standard for their final sale in the form of bars, ingots, sheets or cathodes.

In the mining industry, the sale is normally recognized in application of IAS 18, when the risks and benefits of the seller are transferred to the buyer, the opportunity of how the transfer is to be made is established in advance in the sales contract.

SNMPE (2015) considers that a reasoned examination of the circumstances of the transaction is required to determine when the transfer of the significant risks and advantages to the buyer takes place, involving the property. In most cases, the transfer of the risks and benefits of the property will coincide with the transfer of the legal ownership or the transfer of the possession to the buyer of the concentrate.

The sales can take place in the country or abroad. In local sales the risk transfer usually occurs when the seller delivers the concentrate at the buyer's warehouses. In the case of sales abroad, the transfer of the risk takes place usually on the boarding date when the concentrate is located at the exit port and is ready to be delivered at the place of destination (pp. 163-184).

The sales of concentrate that are made to a local client-usually a trader- include all the deliveries that have been made in a period (month or other agreed period). At the end of the period all these deliveries accumulate in a single liquidation. The mining practice considers that at the time of the final settlement, only one recent sale is considered, however for accounting effects (and normally tax effects), the transfer of the risk happens to the extent that the batches are delivered and the income should be considered executed when these deliveries are made.

For the case of sales abroad, usually different shipments are accumulated in a warehouse near a port to complete the batch exported, in this case, the conditions of these deliveries should be analyzed - as in the previous case- in order to establish what time must be considered for the completion of the sale.

Some types of contracts used by mining companies have tax effects that are not necessarily stated for the purposes pursued by the contractors. Some of the contracts that can generate this type of conflict are the *Holding Certificated* and the *Warehouse Certificate*. As long as the legislation of the countries does not regulate this type of documents (or similar) in order to establish what their tax effects are, we must analyze in each case if the transfer of property occurs or not in the country.

Another type of practice that generates adjustments to the export value is the *Rollback deduction*. The controversy usually generated in these cases is focused on establishing if it is acceptable that mining companies that have referenced their operations to CIF value, deduce the freight and insurance when they claim that the operation is actually done at FOB value. This must be revised in order to avoid an undue deduction especially when we are facing transactions with related companies.

Mining companies establish the *concentrate value* by taking into reference the value of the metal content of minerals found in the concentrate. With the weight data in metric tonnes of the batch of concentrate, the humidity percentage, the "mineral law", the penalizing elements (such as sulphur content), the costs of refining or "maquila" and its variation, and the international quotation of the metal.

The content of the mineral payable will only be established at the time of the refining of the concentrate, a situation that usually occurs a few months after the delivery of the concentrate, the normal practice of the activity is to make a provisional settlement with the best possible estimates. This first settlement justifies the issuance of an invoice and is usually charged 90% of the value of the mineral.

The period of quotation, an important fact to be established in the sale of the minerals, is normally fixed between the first and until the six months after the delivery of the concentrate. At the end of each month, the adjustment to be made is estimated by comparing the final settlement versus the provisional settlement.

When the *international quotation* is used, the price is of fine mineral in the international market. Some minerals that are commodities are bought and sold in what is known as basic products stock market. For Latin America, the London Metal Exchange (LME) is one of the stock market whose prices are mostly taken as a reference.

Subsequently, when all the variables involved in determining the final price are known, the definitive calculation of the concentrate is made and then we proceed to issue the final settlement, the difference between the two settlements is recorded as sale and the price value of the concentrate is adjusted

Given the volatility of prices, some companies, especially those that are linked to international groups-usually carry out hedging operations to minimize the prices risks, sometimes the main contract is acquired by the matrix and allocated proportionately to companies that benefit from the coverage.

Normally these contracts are made with foreign banks. According to accounting rules, hedging contracts are recorded at fair value in the financial statements, the effects of subsequent measurements are recognized in the profit and loss statement, or in assets as appropriate.

These rules are another point that should be assessed to establish the tax effects according to the laws of each country.

To control the adjustments on the quality and the elements contained in the mineral, a good practice is obtaining samples that can be used for checking the adjustments made to batches of exported minerals. This process can be managed by both the tax authority and/or customs and independent laboratories that report these results to the authority in charge of the control.

The signing of agreements of marketing and sales is a normal topic in the mining industry, if these are made with related companies, the possibilities of manipulating the prices and moving the profits from a tax jurisdiction to others is very high.

The control of transfer pricing, in relation to income-related transactions, is necessary in order to prevent the profits generated by the mining activity from being transferred to other jurisdictions without any business reasons or assumed risk to justify this situation.

On the other hand, some investment and/or financing agreements in the mining projects can add more complexity to the issue of determining the income of the project. Some of these contracts offer to attract investment by offering the investor a royalty on the deposit of minerals in payment of regular interests, or offer an investor an interest in the company if it is committed to buy a fixed amount of resources at fixed or variable price. There are also agreements by which investors commit to sell their ore share at the door of the mine to acquire it again later, after a process of concentration and/or refinement, among others.

4.5 Risks associated with operational expenses

In the exploitation phase of a mining project, the production costs will be the most important; these include the costs of depreciation and amortization of long-term assets as we have mentioned before.

The costs at this stage will vary in attention to the type of mining that has been decided, whether underground mining, open pit or mixed, they have different costs. On the other hand, the costs of removing the sterile or low-grade ore increase the operating costs. Understanding how the mine is exploited is a basic requirement to reach an adequate control.

The exploitation stage involves a series of processes -which can be considered as cost drivers- and on which there is an interest on the part of the administration to carry out a correct control; in all the stages mentioned above, documental reporting and custody obligations are important, but it is in the exploitation stage where the control of these documents becomes essential.

Ignorance by officials in charge of control may affect the Administration and the Administered, if they do not know how this process is executed, they may run an excess of audit procedures that increase the costs of compliance for the companies without benefit for the treasury.

Without prejudice to the need to know how mining is organized, there are some relevant issues that must be dealt with correctly, and on which the policies chosen by the companies could have significant impacts on the results of the exercise, one of these topics is corresponding to the *low-grade ores*.

Mining companies normally accumulate low-grade ore, which is not processed because their low concentration is not profitable when taking into account current prices, the same situation happens as the mining company decides to prioritize the processing of high-grade ores. Sometimes these low-grade minerals may not be processed for several years until quotations or mineral extraction technology improve or until there is no longer a high-grade ore available.

Deciding in this situation whether or not to recognize them as an asset is a sensitive subject, defined in accounting by the conceptual framework of the IFRS "assets" are the resources controlled by the entity as a result of a past event and of which it is expected to obtain economic benefits in the future. This being said, if the tax administration has evidence that a "mineralized waste" is liable to be processed to obtain mineral, it may require its recognition as an asset.

4.6 Risks associated with loans and interest expenses

Financing costs in a mining project include costs incurred in financing an entity's operations, and are conformed by interest and other costs generated and linked to the loans.

The International Accounting Standard N° 23- Borrowing Costs- prescribes the accounting treatment of the financing costs.[10] According to IAS, as long as they are directly attributable to the acquisition, construction or production of assets that fulfil the conditions for their denomination as "qualified assets"[11], these must be part of the cost of such assets. The same standard stipulates that other borrowing costs must be recognized as expenses.

In view of the regulation of each country, these costs have a similar or different treatment for the tax effects; in any case, the auditor must be vigilant in order to establish that the treatment admitted by the legislation of the country has been followed.

The auditors must be attentive to these differences to avoid that the accounting option allow obtaining tax advantages not included within the norm. The main risks related to the financing costs lies in that they may not be a consequence of a real liability and/or that these exceed the market values and/or the recognition of a financing cost that reduces the taxable base of the income tax before it is pertinent.

It should be remembered that the accounting standard establishes conditions for the commencement of capitalization of financing costs as part of the cost of qualified assets. They also indicates that it should start when the expenditures are incurred for the asset, incurred in the financing costs, or when the activities necessary to prepare the asset for use or sale are initiated.

The capitalization must consider the period in which the physical construction of the asset was carried out, the technical and administrative work before the commencement of construction, including, if any, the activities related to obtaining permits. Capitalization ends when all the necessary activities to prepare the qualified asset for its planned use or sale are completed.

Remember that the accounting standard states that if the construction is carried out in stages and each stage is suitable to be used while the next one will be built, the capitalization of the financing costs must cease with respect to that which begins to be used. The rules of IAS 23 will not always be harmonized with tax rules, so it is necessary to analyze how the accounting treatment and the corresponding tax adjustments have been carried out.

Special care must be taken with the debt instruments convertible in capital instruments, *hybrid instruments* to which the action 2 and 4 of the BEPS initiative *extensively refer*[12]. These mechanisms are widely used in this sector.

Streaming financing contracts[13] and in general how companies in the sector finance their investments must be fully reviewed in order to avoid abuse. Action 4 of BEPS Project describes some financing mechanisms that generate opportunities for tax planning, and there is a basic need for a re-evaluation of the legal framework applicable to financing and the clarity of the effects obtained with the different instruments involved.

Many countries have specific anti-avoidance rules linked to financing costs, so for example Peru limits borrowing with related parties, and some countries have considered that loan-related interests will not be deductible if they exceeds 3 times the taxpayer's net patrimony.

When countries have incorporated these rules of under-capitalization (or thin capitalization), they must ensure that the statements submitted by taxpayers are sufficiently complete to be able to control the rules. Also, remember that in the process of auditing, not only balances should be reviewed, but also the way the debt evolved in the financial year to sure that the rule is not spurned.

[10] Financing costs are usually the interests and other costs incurred by a company in obtaining loans, such as interest in short-term and long-term loans, interest in bank overdrafts, financial burdens derived by contracts of financial leasing recognised in accordance with IAS 17, foreign-currency exchange-rate differences corresponding to interest adjustments.

[11] "Qualified assets" are considered as those that necessarily require a substantial period before they are ready for use to which they are intended or for sale. The IAS exemplifies that manufacturing plants, hydroelectric, investment properties and specialized machinery, among others, can be qualified assets

[12] BEPS is the acronym for Base Erosion and Profit Shifting, see: Https://www.oecd.org/ctp/10-preguntas-sobre-beps.pdf

[13] See: https://www.imf.org/external/spanish/np/seminars/2015/andean/pdf/sesion3-tenaille.pdf

In cases where a substantial acquired debt exist, the disbursements related to the debt are usually carried out progressively, however in spite of this, these disbursements can be of such magnitude that they are not absorbed immediately by the project, generating this the existence of major balances not used.

These “idle” amounts, while not required by the project, are usually profitable by temporarily placing the funds in financial instruments and/or consigning them to companies of the group. If it is the case, we have to be attentive to the existence of interest income that should be considered, as is the interest expense, for the determination of the income. If market interests have not been agreed for loans to related companies, the application of transfer pricing rules is compulsory.

To ensure the use of money in the project in the case of MNE that generate significant debts to manage their investments around the world, is an even more complicated challenge, because in this case the matrix will “attribute” the portion of interest and additional expenses to be supported by the local company.[14] Here, as in many cases of attributed expenditure, clear rules of accreditation and documentation of operations, as well as transfer-pricing studies are required for a correct control.

Other rules limit the cost of financing – in whole or in part – in the case of indebtedness with residents of countries or territories of low or zero taxation. In addition, for permanent establishments situated or established in countries or territories of low or zero taxation; those obtained from subjects who receive profits, revenue or income through a country or territory of low or zero taxation; etc.

In some cases, this standard is moderated by accepting that the costs will be deductible if the price or amount of the consideration is the same as one that would be agreed by independent parties in comparable transactions.

Thus the use of financial hybrids, taking advantage of the corporate structure of the economic group, and its localization in different territories, can be used by companies that seek their investors to obtain yields without paying taxes, disguising the transactions associated with capital as if they were debt transactions.

The case may be even more serious financial services are simulated, such as coverages, and these coverages were not effectively received and/or the amount assignable to the local company exceeds what would correspond to it in a normal market situation.

In the Peruvian tax legislation, the income generated by derivative financial instruments can be considered yields from economic activities or profits and losses of assets. This treatment is done taking into account the purpose of the operation with derivatives.[15]

Thus, if the derivative instruments seek to cover a risk on an element affecting the business activity and therefore cover[16] elements of the assets or liabilities, the income obtained will have the consideration of yields from economic activities and therefore their effects (gains or losses) can be considered for the determination of the income tax[17].

Likewise, in the mining practice, some types of contracts subscribed may be considered *Implicit Derivatives*[18], such as the sale of ore whose final settlement is carried out in later periods.

It is common to use derivatives to hedge cash flows, interest rates, exchange rates, investments abroad, thus,

[14] One of the advantages previously mentioned in the MNEs is, when operating in global markets, they have the ability to leverage significantly lower interest rates than could obtain a local entity. This advantage is not always “transferred” to the local company. There is a strong tendency to increase even these charges in order to withdraw a greater portion of profits of the project via the payment of interest. Let’s remind that in many cases the income tax rates that correspond to payments for financial expenses tend to be lower than regular rates, thus generating a strong incentive to generate “debt instruments” when it is appropriate to “use” capital instruments. In aggressive cases, companies in the financial system may agree to circumvent the rules indebtedness with related parties.

[15] The problem is the operational treatment during the period from the beginning of the contract until before the expiration of the deadline; this problem exceeds the strictly fiscal scope.

[16] It is generally accepted that a derivative coverage ends when it aims to reduce the effect of future fluctuations in prices or market rates, on the results of the major economic activities

[17] With the only restriction of the necessary presence of causality of the position that is intended to be protected, with the generation of gains within the scope of the tax to be compensated.

[18] An implicit derivative is understood as a component of a hybrid financial instrument that also includes a non-derivative main contract (host). This one generates that some of the cash flows of the combined instrument vary in a similar way to the derivative, considered independently causing any or all of the cash flows of a contract to be modified in accordance with an underlying or variable.

many contracts executed by mining companies can comply with the definition of a derivative instrument. On the other hand, some long-term sale contracts of commodities or long-term contracts to buy electricity or fuel-critical inputs from mining activity depending on their characteristics could be classified as derivative financial instruments and/or have characteristics of implicit derivatives that should be evaluated and recognized for accounting purposes.

To recognize the differences between accounting and taxation with respect to this subject becomes critical in order to be able to control adequately the tax effects of the transactions involved.

4.7 Risks associated with the amortization of long-term capitalized assets

Depreciation or amortization[19] of: (1) capitalized costs[20] of the plant property and equipment elements associated with the project, 2) construction and development costs, 3) financing costs and 4) the amortization of intangibles are usually the main concepts that affect the results of the period in a mining company.

For purposes of depreciation of tangible assets, from the financial perspective, the cost of acquiring an asset should be included and other expenses necessary to be able to use the asset. It should also include the cost of dismantling and removing the equipment at the end of its useful life[21] and the restoration of the place where it was installed, this in line with the provisions of IAS 16.

The use of various depreciation methods is permitted; these include straight line, decreasing depreciation, production units, among others. When an asset depreciation basis has been chosen for the life of the mine[22], it is necessary to determine the proven and probable reserves[23], the mine production plans and plant capacity[24] and the calculation of the mine's useful life[25].

In the mining industry, it is admitted that the method of production units is the most appropriate for the activities of the industry, however it is common for the company to decide that a group of assets or all assets depreciate and/or are amortized, if applicable, following the straight-line method, which is simple and easy to apply.

In these cases, it is to be expected that if the machine or equipment is fully used during its useful life, it could generate significant differences compared with that of production units. Usually, the estimated useful life of the assets when using this method assumes that the production levels do not fluctuate considerably from one period to another.

In SNMPE (2015, pp. 107-116) some common practices of mining activity are collected.

- In the case of amortization of the capitalized development costs, it is carried out according to the useful life of the mine, in some cases, the development investments of certain (independent) sectors that have a useful life lower than the mine, are amortized depending on their own useful lives.
- The practice of the industry is to avoid including in the depreciation the cost of dismantling and removal at the end of the useful life of the asset,

[19] The depreciation and amortization understood as the systematic allocation of the capitalized and depreciable amount of an asset throughout its respective useful life.

[20] The capitalized amount subject to depreciation is defined in the IFRS as the cost of a tangible or intangible asset, minus its residual value in case this applies and is significant.   The residual value is understood as the best estimate of the amount that the entity could obtain on the date of estimation by the disposition of the asset, after deducting the expenses that causes such provision, if the asset had reached the antiquity and the other conditions expected at the end of its useful life (IAS 16).

[21] The useful life is considered as the period during which the entity will normally use the asset, or the number of production units or similar ones expected to be obtained from the entity (IAS 16).

[22] This is very common in the case of permanent constructions or investments in development

[23] The quantity – expressed in metric tonnes – of mineral, which has been measured and expected to be exploited in the future under economic conditions

[24] I.e. the forecast of the annual amount of ore to be extracted from the mine from the proven and probable reserves, which will subsequently benefit the treatment plant. Remember that mine production programs are based on plant capacity (tonnes treated per day), so that all extracted ore is benefited.

[25] The useful life of the mine is calculated by establishing the proven and probable reserves and the annual programs of mining and mineral benefit, with this data the mine's useful life mine can be established by dividing the ore amount included between tested and probable reserves in the annual production of the mine.

as well as the restoration costs of the place where it was installed since these are normally treated within the costs of mines closures.

- It is frequent that the useful life of some assets is fixed by the expectations of the useful life of the mine, instead of the economic life of the asset, this occurs especially at the end of the exploitation of the mines, when the useful life of the mine is lower than that of the asset.

- The general practice is that lands are not depreciated because the value tends to increase or because their life is unlimited, however this is not entirely true in the case of a mining company. While these could acquire a land to supplement their operations or with geological resources, in which case its value could depreciate depending on the life of the mine, even the price paid may exceed the commercial value of the land when the mine closure takes place, this in the event that something could be recovered.

A general practice of the sector is that estimates of the remaining useful life are frequently re-evaluated (at least once a year). Among others, the following situations are considered: (i) the discovery of additional reserves/resources that could extend the size of the mine and its useful life, ii) economic changes in the recovery of resources that imply significant changes in costs or recoveries, iii) significant changes in the mine plan including the decisions to pass from open pit to underground exploitation, iv) The technological development that involves anticipating the replacement of assets allocated to the mine or plant, etc.

Careful consideration should be given to the fact that most mining companies take into account proven and probable reserves when calculating the depreciation of mining assets, in this practice the inferred resources are excluded. This conservative position is acceptable, however in certain situations, if one has the expectation that in the future the indicated and measured mining deposits can be classified as reserves, this would not be reasonable.

These industry practices, as already indicated, may have a different tax treatment, the risks therefore in the activity with respect to the correct control of these charges implies that the tax administration is aware of these differences and elaborate controls that enable them to address adequately the deviations.

In the mining industry, it is often necessary to build a series of assets that will be later transferred to the state or to populations surrounding the project. Many of these constructions, negotiated at the beginning of the project, may involve a series of initial disbursements and/or subsequent commitment to their maintenance. Assets that must be transferred to the state include water-conduction systems, reservoirs, bridges, roads, schools, or hospitals.

In some cases, these assets and/or acquired equipment may be purchased by a group of companies whose operation in the scope of influence of the project can lead them to associate, or share the assets. In such cases, clear rules of allocation and definition of assets are required, as well as their recovery via amortization or consideration as an expense, and what to do in cases of transfer, contributions, abandonment, among other operations that can generate different tax effects.

The legislation must be very clear in the treatment of these disbursements in order to avoid unnecessary conflicts with regard to their tax treatment. The considerations regarding income tax[26], customs duties[27] and VAT, and the mechanisms of early recovery and/or refund in case of export, must be clear, otherwise the conflicts of interpretation will be exhausting, for the state as well as for the taxpayer.

4.8 Risks associated with attributed expenditures

Large business groups tend to take advantage of their market position and the fact of working simultaneously

[26] Depending on the definitions of the tax and sectoral legislation these disbursements could (among other options) be considered “donations”, “expenses” or “other amortizable assets”, each option has a special effect.

[27] Many legislations permit the suspension of customs duties and/or exemption from payment in the case of special assets used in the area of influence of the project for its own purposes, the doubt surges about the later destination of the goods and/or eventually on their use in other places other than the area initially determined.

in multiple jurisdictions to displace the incomes to non-resident group entities that are taxed in privileged regimes[28].

This can be done within the same jurisdiction when, for reasons of tax policy, there are areas and/or activities with privileged tax treatment.

The presence of recurrent losses in a company related to a business group and the fact that the parent or the related companies operating with the domiciled company obtain profits, allows the tax administration to suspect that the losses reported in the jurisdiction are the result of an incorrect *transfer pricing policy*. Unless companies can satisfactorily[29] justify such losses, for a reasonable period, are due to penetration into a new market or the need to expand the market share of a product.

The problem of taxation on the income of local business groups can be reduced by consolidating the income taxation, but even if this option is feasible and compulsory, there will always be doubts about the operations conducted with non-domiciled companies and if transfer pricing regulations are applied properly.[30]

It must be understood that the problem cannot be solved entirely by conducting audits. The transfer pricing audits are usually intensive in the use of highly specialized audit resources, time-consuming regarding their conclusion, and extremely conflictive since the company often questions in all instances the results that are imputed.

It is in the attention of the above-mentioned reasons that *lawmakers* in most countries, intenting to avoid further complications, restrict the compensation of losses from transactions with related companies.

Given the volume of the assets attached to the mining projects, it is normal for the project owners to administer the risks associated with them by partly transferring them to insurance companies. When the project is conducted by a multinational company (MNE), the insurance policies are taken at the central level and their expenses are redistributed among all the beneficiary companies according to criteria that are not necessarily clarified.

Although in principle it is accepted that these expenses are assumed, the lack of clarity of the assets and/or risks covered by the policy when it is acquired by the multinational group and then redistributed to its member units is a permanent concern.

The administrations must be oriented to analyze the position by applying the filters of effective implementation of the expenditure, the causality of the disbursement with the protection of risks, the rationality of the amount allocated to the unit and the market value.

An additional issue to consider is that in some cases insurance policies may be covering risks linked to labor issues that could be considered as higher remuneration and/or acts of liberality within the framework of specific legislation. Here again, the application of the Accounting Standards[31] can be helpful to identify how these disbursements should be treated.

4.9 Impairment of capitalized long-term assets

The mining industry uses long-term assets whose importance is high within the company's assets. The loss of value of these assets is usually evident when the recoverable value of an asset or a cash-generating unit is compared to its book value and it is observed that the recoverable value is lower.

[28] As a reminder, the most common mechanisms to achieve the foregoing are often associated to, among others: exchange of securities to circumvent restrictions of the exemption method, those relating to losses. Contribution between entities of the group to generate losses by reference to a market value controlled by the group itself, creation of a goodwill in non-resident entities relating to resident entities to determine provisionable losses arising from the amortization of such goodwill. Intra-group transmissions to raise the value of shares, which can subsequently generate loss of value by currency depreciation or stock exchange. Participatory structures to take advantage of the exemption on profits and loss calculation. Creation of losses in subsidiaries constituted abroad, through amortizations of goodwill that will be provisioned.

[29] It is obvious that related companies, as well as independents, can have genuine losses. However, an independent company would not be prepared to tolerate losses indefinitely

[30] Even if there is the possibility of determining consolidated results, and that the country as a result of information exchange agreements between tax administrations or as part of the commitments made by the countries in double agreements Imposition can access the confirmation of other tax administrations there will always be a high risk of admitting non-real losses.

[31] IAS 19 and IFRS 2

Assets that may deteriorate[32] include: *installations, plants, machinery, equipment; real estate investments with recognizable cost; biological assets; land; goodwill; Intangible assets*; among others.

There are several reasons for the deterioration of an asset, so the assets can suffer physical damage that will prevent them from operating at their normal capacity[33]. Another reason is the fact that the market in which the entity develops can fall significantly, so that the asset loses total or part of its value in the active market where it was marketed.

Accounting procedures admit that in the mining industry there are facts and circumstances that are indicative of the need to verify the deterioration of the value of assets for exploration and evaluation – for example it is the case when the right to explore expires (or will expire) in an area and the right is not expected to be renewed. A deterioration must be recognized in this case.

Deterioration should also be recognized in cases where the exploration and evaluation of mineral resources in a specific area does not reveal mineral resources that are useful to extract. Nor in cases where it has been decided to interrupt the exploration and evaluation activities in the area or in cases where the amount in the books of the asset recognized in an area because of the activation of exploration and evaluation can be fully recovered through the successful development or through its sale.

The execution of this type of assessment implies that if signs of deterioration are determined, the entity must make a provision for deterioration of value; these provisions are normally not accepted by the income tax regulations, since as provisions they are estimates of expenses that may vary and do not necessarily materialize, and yet can be used.

4.10 Risks associated with the assessment and measurement of inventories

The exploitation in the mine seeks to obtain the mineral in the form appropriate to be sold, the finished products in a mining are the ultimate purpose of the activity, and however these are not the only inventory assets that a mining company manage.

If we remember the provisions of IAS 2 inventories, these are considered to be "... assets possessed to be sold in the normal course of operation;" in production process with a view to that sale; or in the form of materials or supplies, to be consumed in the production process, or in the provision of services. Thus defined, within the framework of the mining activity we can recognize four types of inventories: *raw material*, *supplies and packaging*[34], *merchandise*[35], *products in process*[36] and *finished products*[37].

Mining companies generate stocks of mining products not only for their own production, in some cases, companies acquire inventories to sell them in the near future and generate profits from fluctuations in price or in a marketing margin.

The companies also acquire mining products to mix with their own production and generate an improvement in the quality of their product. Also, when they have an idle capacity installed in their plants of concentration and refining, as consequence of temporary decreases in production, or because they built their plants from the outset considering their production and the eventual transformation of the production of mining farms

[32] It is recommended to review the accounting standard 36 – Impairment of assets. We recommend also revising IFRS 6 "mineral Resource Exploration and evaluation", which provides specific guidelines for evaluating deterioration to be followed in the evaluation process for both assets in the stage of exploration and assets transferred from exploration to the development phase.

[33] The damage can also result from errors in the installation of the equipment that prevent their adequate operation.

[34] It includes all those tangible elements that are used during the process of making a product, for the purposes of mining the fuel, explosives, chemical reagents, grinding balls, spare parts, etc., would qualify within this section.

[35] In the case of the mining activity, the goods bought to another entity and that are available to commercialize are represented here, this item is not usual in mining companies. However, in some mining operations, products are acquired to be provided to the mining contractors via sale or to be placed to the workers by means of a mercantile, and in these cases if it is correct to consider that we are in front of a merchandise.

[36] For a mining operation, this item includes the goods in production process, i.e. mineral crushing, mineral in leaching fields, mineral concentrate (in case of refineries), cathodes in cells, etc.

[37] In the case of mining companies, these would be ore concentrate, copper cathodes, gold or silver ingots, etc.

around the plant to improve their production costs by the economy of scale of the plant.

Mining companies usually apply IAS 2, and therefore carry their inventories at the cost or net realizable value. When the inventories that they maintain are measured by their net realizable value (NRV) The companies make adjustments that reduce the book value the assets (charged to income) precipitating – from the fiscal perspective- losses before they actually occur, if they finally occur, so this accounting policy could have tax consequences.

In accordance with the aforementioned accounting standards the cost of inventories shall comprise all costs arising from their acquisition and processing, as well as other costs incurred to give them their status and location.

Thus, the cost of acquiring inventories must include the purchase price, import tariffs and other taxes which are not subsequently recoverable from the tax authorities and the costs of transport, storage and other costs directly attributable to the purchase of goods, materials or services to be used in the production process. The above amount must be reduced from commercial discounts, promotional sales and other similar items for which the company acquires the right to apply.

In addition, the costs of transforming inventories will include those costs directly related to the produced units, such as the consumption of raw materials and production supplies, as well as the cost of direct labor. They will also include systematic allocation of indirect, variable or fixed costs[38], incurred to transform raw materials into finished products (IAS 2).

Whenever the recovery of the mineral contained in low-grade ore materials during the mining process is decided (leachable material), it is correct that this material stored in leaching dumps will be considered as an asset and therefore activated. This adds to the value of this asset the cost of loading and crushing the material that has been deposited in the fields, in this case the amortization of this asset should be made based on the period of depletion of the leaching dumps.

There are some concepts that IAS 2 requires excluding from the cost of inventories and be recognized as current expenses. For example: abnormal amounts of waste materials, labor or other production costs, the costs of storage unless necessary in the production process prior to a further elaboration process, indirect costs of administration that have not contributed to inventories in their current condition and location, exploration costs, recoverable taxes, expenses related to the environment, sales costs, etc.

Not all concepts previously referred to have a symmetrical treatment in the legislation of the income tax. Therefore here again we recommend to have a thorough knowledge of the policies and accounting practices of the mining entity in review and the understanding of how these practices differ from the tax provisions regulating this type of assets to avoid undue use of deductions.

4.11 Agreements to share risks and costs: joint ventures

In most countries, businesses can be carried out by commercial companies as well as through trusts and contract of partnership in participation. These legal figures are types of contracts that are not normally regarded as mercantile societies and[39] are known in the tax doctrine as *transparent entities*[40].

Some countries treat companies, trusts and other legal entities or contracts as transparent, taxing their associates or beneficiaries according to their holding of shares or shareholdings in the entity on their income, without taxing the entity in itself, while other countries

[38] The accounting practice recognizes that fixed indirect costs that remain relatively constant, irrespective of production volume, whereas variable indirect costs vary directly or almost directly with the volume produced, such as materials and indirect labor

[39] Legal or moral entities, according to the terminology that a country can adopt.

[40] An issue with transparent entities is that their treatment tend to be different in each country, which in some cases leads to double taxation or that in some cases some monetary flows are not subject to levy.

consider them as taxable entities, taxing societies or entities as different taxpayers.

The diversity of treatments that can be granted forces the *lawmaker* to establish appropriate rules for each situation in particular, whatever the country's options regarding to the treatments and restrictions that have been developed previously.

This type of commercial agreements or strategic alliances of temporary character, are frequent in the mining activity, they are characterized by allowing the participating parties to make a joint investment without losing their independence and without that this necessarily gives rise to the creation of a new entity (company, society or other entity).

In these contracts, the associated parties share the risks and costs of the economic activity to be developed, the parties of the joint venture take control of their investment and obtain the part of the income that is generated as a product of the economic activities of the contract according to the terms agreed.

It should be understood that although each partner or venture retains its legal personality and independence, it does not imply that they cease to be responsible for the business as a whole.

Another issue to consider is that the responsibility does not necessarily lie on a proportional basis between the participants. It is possible that one of them assumes greater responsibilities within the business, without implying greater participation in the results necessarily, however we should ask if in this case the remuneration obtained by each venturer correlate with the assets contributed and/or or the risks supported, among other factors that normally independent parties evaluate at the time of negotiate. In addition, the *contract term* can be determined or undetermined.

The tax effects of the transactions made by the participants of these contracts and the one carried out between them[41] must be analyzed within the framework of the law in force in the different countries to establish correctly their tax effects.[42]

4.12 Treatment of compulsory procurement agreements with suppliers and service providers

Given the location of the mining project, the compliance standards required from suppliers and the need for uninterrupted services, mining companies tend to hire third parties with a "mandatory buy and pay" clause. Under this clause, the project is compelled to pay a provider for the services received, whether or not the service is provided and the income that corresponds to these services is received, in cases of fortuitous event or force majeure attributable to the mining project.

These contracts also include important punitive clauses to the supplier if the provision of services is breached; this way the relationship between supplier and client becomes somehow symmetrical, allowing the flow of production of the mining project to be kept uninterrupted except for cases-as already mentioned-of fortuitous events or "acts of God".

These services can also be provided by related companies, in which case, the risk of the transaction between related companies is resurfacing. Even in the case of independent companies, the treatments that could be given to these events could be discussed. For example in some legislations with a very strict definition of causal expenses, the amounts paid that are not related to the benefit of services and which can be considered penalties could be rejected, on the other hand for either party, these income could be considered unaffected by the tax, since they are not ordinary incomes.

[41] Unless otherwise agreed, the contributions in goods do not carry transfer of ownership but their usufruct.

[42] For example, in Peru, the General Law of Companies has not regulated the business model joint venture or shared business, having regulated other associative models such as the contract of association in participation and the contract of consortium. Without prejudice to this, in the Unique Ordered Text of the income tax law, some specific rules for the joint venture have been considered.

To reduce the conflicts of interpretation and make predictable to both parties (administration and administered) the appropriate tax treatment, it is essential to provide clear delimitations on the treatment that should be given to these operations.

5. CONCLUSIONS

The management of the compliance risks is a process to identify, analyze, prioritize and mitigate the taxpayers' compliance risks; and it should be used in a structured manner by the tax administrations.

The adoption of risk management practices in the segment of medium and large mining is critical for many tax administrations in Latin America and the Caribbean.

This document has presented a sample of the critical issues in the mining industry; although not exhaustive, it allows characterizing the activity and point out elements of attention to those responsible for the control at both the central and operational levels of the administrations.

The importance the existence of a robust legal framework for the mitigation process should not be forgotten, as well as the promotion of standards that in many instances eliminate and/or control a risk. The administrations therefore should devote a time to analyze and review the functioning of the tax system in order to improve it, and this document has shown points where clear definitions would reduce the conflict between the administration and the taxpayer.

From the previous summary, the key areas of control include precise definitions of the definition of the project, both its income and its expenses, and rules for defining the expenses eligible to be deducted. In addition, it requires definitions on the treatment of expenditure for each phase and rules of apportionment or allocation, to which must be added the amortization rules of the expenses incurred and/or capitalized corresponding to a previous stage.

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CRITERIA FOR THE INCLUSION OF TAXPAYERS IN A LARGE TAXPAYERS UNIT

A METHODOLOGICAL GUIDE

Elías Iván
LÓPEZ ROCHA

SYNOPSIS

This paper presents a review of the main criteria that the countries of the world use to incorporate taxpayers into their respective Large Taxpayers Units. Based on this international experience, the document proposes to the tax administrations a methodological guide to define criteria to identify taxpayers to be included in the respective Large Taxpayers Units of each country, according to their own national reality.

CONTENT

1. The creation of Large Taxpayers Units (LTU)
2. Countries' criteria for the inclusion of taxpayers in LTU
3. Number of taxpayers included in a LTU: Peruvian case
4. Methodological proposal to define criteria for the inclusion in a LTU
5. Conclusions
6. Bibliography

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INTRODUCTION

In all countries, it is possible to identify certain taxpayers who, because of their relative importance in the national tax collection, are considered as large taxpayers. In this regard, the Organization for Economic Cooperation and Development [OECD] (2013) points the most common characteristics in this type of taxpayers. They i) concentrate a high share of the tax collection; ii) their business and tax facts are of high complexity; iii) they have a higher tax compliance risk; iv) they hire teams specializing in tax advice; and v) their companies are listed on the stock exchange, are multinational or constitute economic groups.

Faced with this reality, in recent decades the tax administrations of a large number of countries have opted to create offices specialized in providing a differentiated treatment to the segment of large taxpayers; These offices are known as a Large Taxpayers Units (hereinafter LTU). Empirically, it is more or less simple to verify that in all countries, there are certain taxpayers who, because of their fiscal importance, are described as "large taxpayers", but when we need a dividing line of distinction between large taxpayers and those who are not, the task becomes more complicated.

For example, the easiest way to classify taxpayers by their size could be to use the sales volume as a criterion, assuming that in a hypothetical country it is decided that the large taxpayers are only those with sales exceeding 10 Million currency units (CU). How do you classify two companies in the same category that belong to the same owner and that each sells less than 10 million CU? On the other hand, what would happen to a company that is running a mega investment project of thousands of millions of CU, but that to date does not record sales because it is in pre-operative stage? The answers to these questions reveal that establishing a single criterion seems not to be an ideal solution for identifying the large taxpayers.

On the other hand, this hypothetical country could decide to widen the number of criteria for the identification of large taxpayers in order to cover the vast range of possibilities that economic reality presents, but in this case, what would be the limit? It should be taken into account that a very extensive and cumbersome procedure for the classification of taxpayers by their size could become costly and impractical for the tax administration.

The design of criteria for the inclusion of taxpayers in LTUs is of special interest to the tax administrations because the delimitation of the amount of taxpayers that will be included in a LTU is the starting point to determine the amount of staff and resources that this unit should count on. In addition, once we know how many and who are the big taxpayers, we can design and apply better strategies to optimize the management of the tax compliance of this important segment.

In this regard, the present paper offers a brief review of the main inclusion criteria to a LTU applied by the countries of the world and, from this international experience, we propose to the tax administrations a methodological guide to design their inclusion criteria for their respective LTU, according to the reality of each country.

1. THE CREATION OF LARGE TAXPAYERS UNITS (LTU)

The organizational structures of the tax administrations in the world have been evolving in the last thirty years. In this regard, the OECD (2011) mentions that this evolution comprises three types of models; the first and oldest is the model based on the organization "by tax type", in which multifunctional offices were in charge of the specialized taxes. Over time, this model became inefficient and onerous because many processes were duplicated and taxpayers affected by various taxes complicated their tax compliance by having to deal with similar issues with different offices.

Subsequently, the tax administrations evolved towards an organizational structure of type "functional", where the human resources are grouped by functions, where the most traditional are: Collection, Audit, Recovery and Claims. This model has as an advantage that it allows the standardization of the working processes and a simpler operative approach towards the taxpayers; however, the most recent trend is to organize processes around a model of "segmentation by type of taxpayer." This model consists in identifying groups of taxpayers that by their characteristics require a differentiated treatment by the tax administrations, as it is the case for the segment of large taxpayers (OECD, 2011).

The study conducted by the Inter-American Development Bank with seventeen Latin American countries found that the types of organization that predominate in the region respond to a combination of the models "by tax", "functional" and "by type of taxpayer." Sixteen of the seventeen countries reported that they have a LTU (IDB, CAPTAC-DR, CIAT, 2013).

Table 1: Organizational model of Tax Administrations in Latin America

Type of organization	Number of Countries
Only by type of tax	0
Functional only	4
By type of taxpayer only	0
Functional and by type of taxpayer	6
Functional, by type of taxpayer and by type of tax	7
Total	**17**

Source : IDB et al. (2013, p. 96) Adapted by the author.

2. CRITERIA FOR THE INCLUSION OF TAXPAYERS IN A GLOBAL LTU

The OECD (2013) presents six criteria for the inclusion of taxpayers in a LTU among the member countries of this organization. i) volume of operations or gross sales, ii) volume of assets; iii) total taxes entered into the Treasury in one year; iv) economic sectors to which business belongs (e.g. banking, insurance, oil); v) business with significant international commercial activity or controlled by foreign economic groups; and vi) number of employees.

The annex presents the criteria for the inclusion of taxpayers in a LTU adopted by eight OECD countries. We can see that in general these countries share the above-mentioned criteria; however, each country varies in the parameter of measurement adopted for each criterion. For example, for the "volume of operations" criterion, in Australia the parameter is a turnover higher than AUD 250 million (about EUR 169 million), while in France, operations must be more than EUR 400 million, in Ireland operations must be above EUR 162 million and in UK operations have to be higher than EUR 50 million (OECD, 2009).

On the Latin American side, the criteria that predominate in this region for including taxpayers to a LTU are: i) turnover; ii) volume of assets; iii) taxes paid to the Treasury; and iv) the economic sector of the taxpayer (IDB, et al., 2013).

Specifically, in the case of the Pacific Alliance countries: Chile, Colombia, Mexico and Peru, the tax administrations of the first three publish the criteria for the inclusion of their taxpayers in their respective LTU[1], while in Peru these criteria are not published. Only the list of the last taxpayers that have been included in this category by the corresponding resolution is shown on the Peruvian Tax Administration Web site[2]. However, in the study of IDB et al. (2013) Peru reports that the inclusion criteria on its LTU are: i) turnover; ii) volume of assets; and (iii) taxes paid to the Treasury.

3. NUMBER OF TAXPAYERS INCLUDED IN A LTU: PERUVIAN CASE

In Peru, the LTU responsible for the administration of the most important taxpayers in the country is called the Intendance of Major National Taxpayers (hereinafter IPCN in Spanish) who manages around 2,400 taxpayers. However, they are not the only major taxpayers of Peru, since the decentralized organizational units of SUNAT[3] are also in charge of another group of large taxpayers from their respective region. Together with the taxpayers of the IPCN, they include approximately 14,000 large taxpayers nationwide; however, in this work we allocate only to the SUNAT's IPCN the category of LTU, because it concentrates the largest taxpayers in the entire country.

[1] For more information on the criteria and parameters for inclusion in a UGC in these three countries, the reader can consult in the case of Chile, *Resolución Exenta* No. 119 of December 29, 2015 of the *Servicio de Impuestos Internos*. In the case of Colombia, *Resolución No. 00027* of January 23, 2014 of the *Dirección de Impuestos y Aduanas Nacionales*, and in the case of Mexico, see Chapter VII (B) of the *Reglamento Interior del Servicio de Administración Tributaria* of August 24, 2015.

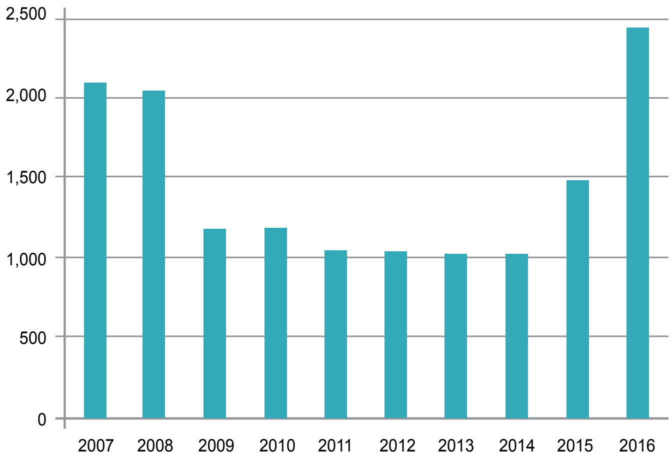
[2] As an example of the Peruvian case, the reader can consult the *Resolución de Superintendencia Nº 242-2016/SUNAT* of September 22, 2016.

[3] SUNAT: *Superintendencia Nacional de Aduanas y de Administración Tributaria*. This is the Tax Administration of Peru.

Although currently SUNAT does not make public its criteria for the inclusion of taxpayers in its LTU, these criteria indeed exist and are internal. In the last ten years, these criteria have been modified on several occasions and as a result, the number of taxpayers on the list of the IPCN has recorded great variability, as illustrated in Figure 1. Thus, we can identify up to three moments that represent for the SUNAT breakpoints in the dimensioning of the number of taxpayers included in the IPCN list:

- Year 2009: IPCN taxpayers ' list decreases by half.
- Year 2015: IPCN taxpayers ' list increases by 50%.
- Year 2016: IPCN taxpayers ' list increases by 60%.

Figure 1: Historical evolution of the list of Large Taxpayers in Peru (Number of taxpayers per year)



Source: SUNAT resolutions that remove or include the large taxpayers from the list.
Created by the author.

Any significant variation in the number of taxpayers administered by a LTU represents a risk to the administrative and tax management, due to the impact of this increase/decrease in taxpayers on the dimensioning of human and logistic resources that the LTU must budget to attend the various processes such as collection, audit, claims and recovery.

For example, one of the most common indicators in the control management is “coverage of control actions”, understood as the ratio between the number of audited taxpayers and the number of taxpayers administered. Then, if at any given time the number of taxpayers administered (denominator) increases to double, it is going to be impossible that with the same amount of resources (inspection agents and the logistics that accompany them) can reached the number of audited taxpayers (numerator) needed for the ratio to even remain stable. This is not the only problem, since the administration may immediately increase the resources of the unit, but in the case of a LTU, which as mentioned, has unique characteristics that differentiate it from any other unit, how much time will demand the learning curve of the new resources? It is likely that in the short term the quality, efficiency or efficiency of the services provided by the LTU is affected.

On the other hand, when there are significant changes in the number of taxpayers listed in a unit and repeated over time, the monitoring and control of the various management indicators of the unit becomes more complicated. In a practical example, the management results obtained in one year on a universe of 1.000 taxpayers cannot be compared with the results obtained in the following year on a universe of 2.000 taxpayers. Moreover, if a few years the list increases again, let us say by 50%, the interannual comparison to evaluate the progress of management will be further complicated, hindering the construction of time series for the evaluation of long-term strategies.

This does not mean that a LTU should have an unmovable taxpayers list, which would be simply impossible because taxpayers are living entities that are born, grow, change and also die, so it is reasonable to expect that the amount of taxpayers attached to a LTU are in permanent change. What this paper postulates is that tax administrations must have standard criteria for the inclusion of taxpayers in their respective LTU. This way, there is predictability about how many and who should be the large taxpayers of the country so we can better dimension the necessary human and logistic resources, as well as to design strategies and policies for an efficient administration of this important segment of taxpayers.

4. METHODOLOGICAL PROPOSAL TO DEFINE THE CRITERIA OF INCLUSION IN A LTU

Several research works by the OECD and other international organizations demonstrate that there are, at world level, six inclusion criteria for an LTU. i) volume of operations or gross sales, ii) volume of assets; iii) total taxes entered into the Treasury in one year; iv) economic sectors to which business belongs (e.g. banking, insurance, oil); v) business with significant international commercial activity or controlled by foreign economic groups; and vi) number of employees. In this way, the present work includes this international experience and from it proposes a methodological roadmap, a kind of "check list". We make it available to the tax administrations of the countries that still do not have a LTU, or if they have one, have not yet defined or want to redefine the criteria distinguishing the taxpayers who should be categorized as large and those who do not.

Our proposal to define the criteria for inclusion of taxpayers in the LTU of each country consists of four steps:

i. Define the universe of taxpayers to evaluate.

ii. Evaluate each of the six most widely disseminated criteria internationally.

iii. Evaluate to include some criterion other than the traditional six, according to the reality of each country.

iv. Include a scope of discretion.

4.1 Define the universe of taxpayers to evaluate

This methodological proposal is covered by the Pareto Principle, since empirical evidence shows that only a small percentage of the taxpayers' universe represents the greatest tax interest of a whole country.

Therefore, the first thing is to define the universe of taxpayers to evaluate. For example, in certain tax administrations a decision may have been made that high net worth individuals be controlled by a specialized unit outside the LTU, then flat-out these taxpayers should not be part of the universe to evaluate. Similarly, it should be reviewed whether certain types of taxpayers, such as state entities or non-profit organizations, have been excluded by internal decisions of control in charge of the LTU.

In every country, there are thousands and even millions of taxpayers who belong to special or simplified taxation regimes for the promotion of small and micro enterprises, these taxpayers should not be part of the universe to evaluate because their current economic dimension is far from pretending to be part of the large taxpayers of the country. The central idea of this first step is for the tax administration to define a universe of taxpayers, representative of their national reality, on which they will apply the proposed criteria, to elucidate who is a great taxpayer and who is not.

4.2 Evaluate the six criteria most widely spread internationally

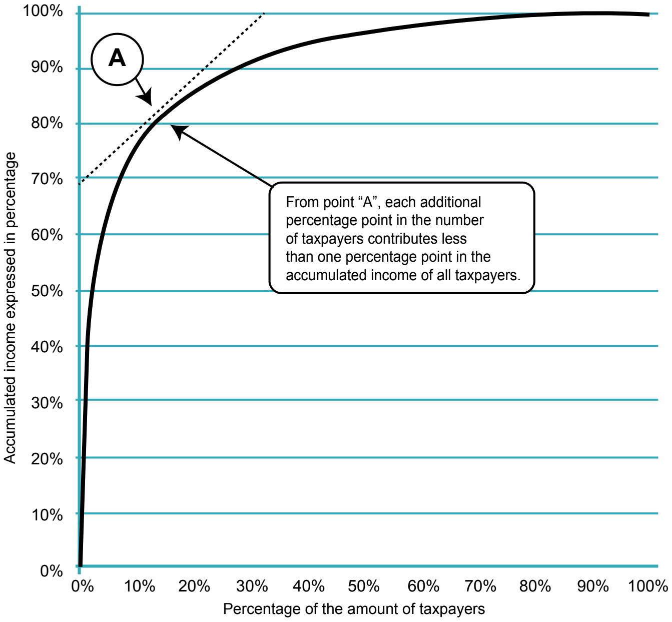
i. Volume of operations

It establishes a lower limit to identify as a large taxpayer anyone whose income exceeds this limit. The simplest way is to use the income declared in the last period, but it is also usual to use an average of the income declared in the last two or three years.

To find the threshold, we propose to elaborate a curve that reflects the Pareto Principle, that is to say, first to build a table of percentiles with all the taxpayers in evaluation ordered from greater to lower by their level of income. Then, in a graph, we place on the X-axis the percentage of the amount of taxpayers, and on the Y-axis, the accumulated income expressed in percentage. Finally, find the tangent point of 45 º to the curve to establish there the limit point from which an additional 1% of taxpayers begins to contribute less than 1% of the accumulated income. We argue that this point indicates a reference limit that any tax administration must take into account in order to introduce a criterion of distinction for the large taxpayers.

For a better illustration, let's review the hypothetical case of Figure 2; point "A" corresponds to the tangent point from which each additional percentage point in the number of taxpayers contributes less than one percentage point in the accumulated income of all taxpayers; So assuming that this point is (x = 14%, y = 81%) We interpreted that 14% of taxpayers account for 81% of the total income declared by the universe of taxpayers assessed (in compliance with the Pareto Principle). As a result, the level of sales of the last taxpayer of the 14% percentile would be the reference limit, that is, those considered as large taxpayers should be those who declare income higher than this limit. It is very probable that the resulting number is extensive and difficult to remember, therefore it is advisable to establish as a definitive criterion a round number, easy to remember and above the threshold.

Figure 2: Distribution of income declared by the universe of taxpayers who are object of evaluation



From point "A", each additional percentage point in the number of taxpayers contributes less than one percentage point in the accumulated income of all taxpayers.

Created by the author.

ii. Volume of assets

The "volume of operations" criterion alone does not ensure a complete identification of all taxpayers that by their characteristics must be included in a LTU. Such is the case for example of taxpayers who are in pre-operative stage or in start of operation, that at the date of evaluation do not record yet important revenues, but that the level of investments in assets makes foresee that in the near future will generate taxable income of great fiscal interest to the country.

In order to find these taxpayers we propose to repeat the same methodology used for the criterion "volume of operations" using as an evaluation measure the volume of the total net assets declared by all the taxpayers. If a more restricted measure is desired, it may be decided to consider only the net total of non-current assets. The result will again be a distribution curve similar to Figure 2, where we can identify the threshold from which a taxpayer may be considered large in relation to their volume of assets. It is to be hoped that many of the taxpayers with high volumes of assets are the same as those already included in the LTU because of their high levels of operation, but some new taxpayers will also appear that on the date of evaluation did not record significant revenues. However, their volume of assets makes them presume a potential level of operations of enormous tax interest.

Thanks to this criterion, we will be able to identify for example taxpayers who are in charge of large investment projects that are in pre-operative stage and that are of high impact for the national economy.

iii. Taxes collected

This criterion allows identifying taxpayers who do not have enough income or assets to be detected in the two previous criteria, but whose contributions to the Treasury are of interest for the monitoring and control by the Tax Administration. Such is the case for example of services companies that are not capital intensive (low asset level) and have high profit margins, and are required to pay as much or more taxes than companies in other sectors with higher income levels. Another example may also be governmental or non-profit entities that do not report taxable income, but do register an abundant payroll of employees who pay significant amounts of income tax and social contributions to the Treasury.

For the application of this criterion again we propose to use a distribution curve (as in Figure 2) using this time as a measure of calculation the total of taxes collected. In this way, we could find the threshold from which taxpayers who perform major payments to the Treasury must be considered for inclusion in the LTU. Similarly, many of the taxpayers found are expected to be the same as those found with the previously described criteria, but new taxpayers with relevant revenues to the Treasury will also appear.

iv. Economic sectors

This criterion proposes that taxpayers who belong to certain economic sectors whose operations are very complex or are very sensitive to the country's economic performance must be included in the LTU , regardless of the volume of operations of these taxpayers. For example, internationally it is widespread that the financial and insurance activities are a sector of high complexity in its operations and therefore must have a special follow-up on the part of the tax administration[4]. On the other hand, there are certain specific sectors that are key in the economic development of countries, for example mining for Chile or South Africa or hydrocarbons for Saudi Arabia or Norway, therefore their respective tax administrations have an interest to include the taxpayers of these sectors in their LTU.

Our proposal is that according to their own economic reality, each country must evaluate whether there are certain sectors, such as those mentioned above, whose taxpayers should have special control and follow-up by their respective tax administrations. Thus, for these taxpayers, their level of operations, assets or payments to the Treasury would not be as relevant, but their belonging to these sensitive and complex economic sectors. However, the administration should evaluate the relevance of establishing at least a minimum limit to prevent taxpayers of very low tax interest from being included in the LTU.

v. Economic groups

The economic groups can be national or multinational, diversified or concentrated in a single sector; they can be of family shareholding or of open shareholding, in any way the economic groups are of indisputable fiscal importance because of their high risk of compliance. An example of their relevance to international tax control is the promotion of the BEPS[5] programme by OECD. This program aims to combat the international tax planning through which companies (especially multinational economic groups) take advantage of legal loopholes in the tax rules of certain countries to transfer their profits to other territories where the level of taxation is lower or even null.

For this reason, we propose that the fiscal administration of the economic groups be managed by specialized teams, and these teams should be located in the LTU, because the large corporations and companies that are head of the economic groups usually are included into the LTU list.

We postulate that it is not necessary to include in the LTU all the companies of a specific economic group, because many of them would be taxpayers of a lower tax importance that would not fulfil any of the criteria of incorporation already mentioned. However, in order to exercise the faculty of fiscal control, we maintain that the LTU must have the power to incorporate whenever it deems convenient any company that belongs to the economic group of a taxpayer registered to the unit.

vi. Payroll of employees

This is a more widespread criterion in European countries than in Latin America. Most likely, almost all taxpayers that have a large employee payroll have already been identified with one of the above criteria. However, it is also possible that there are some other taxpayers who, despite having operations, assets or tax payments of minor relative importance have a very large payroll of employees of interest to the control of the tax administration and therefore their inclusion in the LTU is decided.

Another utility of this criterion is that it can serve as a complement to the criteria of "economic sector" or "economic group". I.e., the tax administration could choose to approve as criterion of inclusion in the LTU taxpayers that belong to certain sectors or the same economic group, as long as the number of employees exceeds a minimum amount established.

In countries like Peru, where only 3 out of 10 workers are formally declared (MTPE, 2015), this criterion may not be of much use, due to the lack of information.

[4] Belonging to the financial and insurance sector is an express criterion to be included in the UGC in the following OECD countries: Germany, Australia, Chile, Spain, Greece, Holland, Hungary, Ireland, Mexico, Norway, Poland, Czech Republic, Slovak Republic and Sweden.

[5] Acronym of Tax Base Erosion and Profit Shifting.

4.3 Evaluate to include some criterion other than the traditional six, according to the reality of each country

As the political, economic and tax reality of each country has its own peculiarities, it is pertinent that each tax administration evaluates the need to incorporate specific criteria other than those already mentioned for the inclusion of taxpayers to their respective LTU. For example, Colombia has considered relevant to include the criterion that the FOB value of exports or CIF of the annual imports exceeds 10 million of American dollars. For its part, Chile has included as criterion if the average annual exports of the last 3 years are equal to or greater than 20 million of American dollars. Mexico has considered as criterion of inclusion in its LTU to be a foreign State, international agency, member of the Mexican Foreign Service, or members of the foreign diplomatic and consular personnel. In conclusion, each country must assess whether it requires some type of inclusion criterion other than those already mentioned by this methodological guide, in accordance with its own reality.

4.4 Include a discretionary criterion

The criteria proposed so far may well ensure that the most important taxpayers in each country are included in the LTU list, but the reality is always more complex and unpredictable than the theoretical assumptions. For this reason, foreseeing that a powerful reason could emerge to include in the LTU taxpayers who do not comply with any of the criteria already exposed, this methodological guide proposes to add a discretionary criterion that offer flexibility to the tax administration to incorporate these taxpayers into the LTU. In order to prevent this criterion from being arbitrary, including in the LTU a taxpayer that does not meet any of the prerequisites should be approved by a competent authority of the tax administration and should be based on reasons of service or control.

5. CONCLUSIONS

- The creation of a LTU in the tax administrations is today a widely disseminated practice, due to the fiscal importance that the large taxpayers segment represents for each country.

- The design of standard criteria for the inclusion of taxpayers in a LTU is very important because the quantification of the amount of taxpayers that the LTU will manage serves to estimate the amount of human and logistic resources needed for their good operation. On the other hand, standardized criteria restrict the likelihood of abrupt changes in the number of taxpayers administered by the LTU and offer the necessary predictability to design better strategic plans in order to optimize the tax compliance of the large taxpayers segment.

- At the global level, the six most common criteria for the definition of criteria for the inclusion in a LTU are:
  i. Volume of operations
  ii. Volume of assets
  iii. Taxes collected
  iv. Economic sectors
  v. Economic groups
  vi. Employee Payroll

- This paper offers to the tax administrations a simple methodological guide on the steps to be taken to design criteria for the inclusion of taxpayers in a LTU. The steps are four:
  i. Define the universe of taxpayers to evaluate.
  ii. Evaluate each of the six international criteria most widely disseminated.
  iii. Evaluate to include some criterion other than the traditional six, according to the reality of each country.
  iv. Include a discretionary criterion.

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FOREST BIOLOGICAL ASSETS NIC 41
AND THEIR IMPACT ON INCOME TAX IN ECUADOR

Marlon
MANYA ORELLANA

SYNOPSIS

Since companies devoted to agricultural activity use the historical cost model in their accounting system for registering and measuring the asset, and since the latter undergoes continuous biological transformations, this article is focused on analyzing the tax treatment of forest biological assets (forestry, TECA case study), through the reasonable value model, considering tax effects on Income Tax in Ecuador.

CONTENT

1. Application of systems for asset valuation in Latin American countries
2. Accounting and tax analysis in the adoption of Forest Biological Assets
3. Recognition and measurement in the adoption of Forest Biological Assets
4. Conclusions
5. Bibliography

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INTRODUCTION

According to information from PRO ECUADOR, Export and Investment Promotion Institute in its “2016 Forest Sectorial Profile”, forestry, lumber extraction and related activities that comprise the growing, care and exploitation of forests, showed a total amount of production of US$1,216.57 million, while lumber by-products accounted for US$1,742.13 million. In sum, these products represented 1.72% of Ecuador’s total production and 2.93% of that year’s GDP.

Said economic activity is being promoted by incentive programs proposed by the Government for encouraging forest plantations to generate economic resources, value added in export lumber, with a view to promoting a change in the country’s[1] productive matrix. Nevertheless, a common problem is that the user has very little knowledge about the productive process of the plantations and the administrative processes required to access different markets. Within this process, there is the issuance of exploitation and transportation permits. In addition, and no less important is the fact that companies require information about accounting procedures and treatments, and an adequate valuation of their assets, since they undergo constant biological transformations due to their nature.

In this regard, currently there are many countries in the process of application of the International Financial Reporting Standards (IFRS). The countries of the region are included in this process given the need to adopt a standard and high quality financial language. Many economies demand the use of IFRS in the case of national businesses that are listed in the stock exchange. Included are Brazil, Chile, Mexico and Ecuador, while other countries like Argentina, require that some companies that are listed in the stock exchange prepare the financial statements in accordance with the IFRS. In the case of Bolivia and Paraguay, they allow but do not demand the use of IFRS by the national businesses that are listed in the stock exchange.

Ecuador started adopting the International Financial Information Standards in 2010 through a Resolution of the Superintendency of Companies. Among the measurement models included in the IFRS, there is that of reasonable value. The terms established for the measurement at reasonable value create new practices in the accounting and financial sphere, it being necessary to use estimations and professional judgment, which previously had not been taken into account neither in Ecuador or the region.

It is thus that one type of asset that should be measured at a reasonable value is the “biological” one. A biological asset is defined in the IFRS as a living animal or a plant. In case the reasonable value cannot be reliably measured, the entity may measure the biological asset at the historical cost. In practice, it has been seen that companies dealing with agricultural, forestry and fishing activities apply the historical cost model without actually evaluating the applicability of the reasonable value model. In the face of this scenario, this article endeavors to analyze the measurement of forestry biological assets, specifically within the forestry activity through the case study of TEAK and its incidence in Income Tax in Ecuador.

1. APPLICATION OF ASSETS VALUATION SYSTEMS IN LATIN AMERICAN COUNTRIES

A study prepared by Ivanovich, Peña, Torres[2] compiled information from 25 complete surveys from nine countries. It was addressed to academicians of the region who, as experts and researchers of the subject, or else affected by the convergence process have an opinion as well as experience on how this process is being carried out. It shows the main changes, the most important being:

1.1 Accounting objectives

Current situation: Provide information to third parties. Tax compliance

Source of change: Conceptual Framework of IFRS

Expected situation: Provide information that may be useful for decision-making

[1] The Program on Incentives for Reforestation with Commercial Purposes was officially presented in 2013 and it is expected that by 2017 there will be 120,000 reforested areas. http://balcon.magap.gob.ec/mag01/magapaldia/WEB%20FORESTAL/GuiaForestal002.pdf

[2] A critical analysis of the IFRS and the processes of adoption and implementation in Latin America and the Caribbean 2012.Research macro project.

The results show a trend toward taxation, which is evidenced through the persistence of the objective involving the strict application of the tax regulation as the most important accounting objective (67%). This objective is followed by the decision-making process (56%) and, subsequently, by control and accountability to third parties (44%). These latter objectives are related to the information purposes with respect to the business, and on the other hand, how this information is useful to third parties.

1.2 Accounting principles

Current situation: Diversity of principles where the substance prevails over the form and conservatism

Source of change: Conceptual Framework of IFRS

Expected situation: Business in progress, base earned and accounting period.

Until the appearance of the convergence process in the region, all the countries had their own accounting principles, where the most important ones in the region were conservatism, business in progress, earned and collected.

1.3 Influence of taxation

Current situation: Different levels of influence of the regulating entities in compliance with the national tax standards.

Source of change: New concepts, language, presentation and disclosure of financial information.

Expected situation: Of no greater relevance, except the importance of knowledge of the rules by the examiners in carrying out the examination and audit.

With respect to the influence of taxation in accounting practices, there is a clear trend toward systems highly regulated by the Government. There are countries such as Mexico, Argentina, El Salvador, Panama, Peru, that declare themselves committed to the regulating entities, while there is a trend toward regulation such as in Chile, Honduras, Ecuador; while in Cuba there is a certain level of balance between the accounting and said organizations.

According to these results, it may be said that, in the region, there is a trend toward respect for the institutions and local regulations above the rules or criteria that could originate from the professional practice. The foregoing is influenced by the convergence process given that, as observed in the actors that have led the convergence process there is a trend toward carrying it out in a mixed manner from the professional associations and State entities.

1.4 Appraisal practices

Current situation: In keeping with the influence in the development and application of assessment models according to the historical evolution of each system (Anglo-Saxon, continental or examination). In general, strong emphasis on the historical cost.

Source of change: Reasonable value and other sources of assessment at market values.

Expected situation: Assets: historical cost, reasonable value, assessment value and present value. Liabilities: Amount of funds received at current value, payment value not discounted, present value of flows.

With respect to practices regarding the assessment of assets, the conservative principle is one of the most common in the region and relates to the way of assessing the assets in an entity. The International Financial Reporting Standards pose a new paradigm known as reasonable value as common criterion for the determination of the value, from a perspective more closely related to the business and the markets where most of the goods and services are commercialized. In most of the countries of the region, the historical cost prevails. However, one may also observe that in countries such as Mexico, Argentina and Ecuador, this method was combined with a vision more focused on the market.

Countries	Historical cost	Replacement cost	Reasonable value	Other
Argentina				X
Chile	X			
Cuba	X			
Ecuador		X (50%)	X (50%)	
El Salvador	X			
Honduras	X			
Mexico	X (43%)			X (36%)
Panama	X			
Peru	X			

Source: Ivanovich, Peña, Torres

For these reasons, in the professional practice, it has been observed that businesses devoted to forestry, as well as other businesses that manage other types of biological assets in the agricultural activity, do not evaluate the applicability of the reasonable value (less sales costs) as provided in the IFRS, nor have they had experience therewith. The historical cost model is the only one applied for the registration and measurements of these assets.

2. ACCOUNTING AND TAX ANALYSIS IN THE ADOPTION OF FOREST BIOLOGICAL ASSETS

Within the regulatory set of International Financial Reporting Standards, IFRS, the biological assets are treated according to IAS 41 – Agriculture (IAS 41). The first paragraph as transcribed below clearly, defines that all those biological assets related to the farming activity are within its scope:

"1 This Standard must be applied in order to account for the following, provided it is related to the agricultural activity:
(a) biological assets;…"

The standard applies for the accounting treatment of changes occurring in the biological assets, estimates of agricultural products at the harvesting point, measured at reasonable value less sales costs. They will be subsequently considered in IAS 2 of Inventories. It finally covers the official subsidies granted by the Government, provided they are related to the agricultural activity. For example:

Biological asset: Tree in a forest plantation

Agricultural products: Trees that have been cut down

Resulting products: Trunks, wood

The criteria for recognizing the biological assets are identical to the general criteria for recognizing the assets in the IFRS, with some exceptions with respect to assets dealing with extractive activities and some intangible assets acquired in business combinations. Paragraph 10 of IAS 41, transcribed below, provides for these recognition criteria:

"10 The entity will recognize a biological asset or an agricultural product when, and only when:

(a) the entity controls the asset, as a result of past events;

(b) it may be probable that future economic benefits related to the asset may flow to the entity; and

(c) the reasonable value or cost of the asset may be measured in a reliable manner."

The forest biological asset will be measured at the time of its initial recognition, as well as on the date of each balance, in keeping with its reasonable value less estimated costs at the point of sale. The forest plantations produce profits or losses as a result of the initial recognition of a biological asset at its reasonable value less its estimated costs at the point of sale when there are biological changes (for example: increase in the diameter and height of a tree, change of prices in the market, etc.).
In the same manner, another binding accounting standard results from the measurement of the reasonable value, which is provided in the International Financial Reporting Standard - IFRS 13. This standard provides that in order to measure the reasonable value, one must consider the main market or most advantageous market. It also states that the measurement will consider assessment techniques,

for evaluating the price of the asset or liability to be exchanged, as described below:

- **Market Approach.-** Uses relevant prices and information resulting from the negotiation of equal or comparable assets or liabilities; that is, participants interact in a main market..

- **Cost Approach.-** At certain times, the initial costs incurred may be adequate approximations of the reasonable value, provided there are little changes in the biological asset as of the time the costs were incurred and significant biological changes in the plantation are not expected.

- **Revenue Approach.-** The revenue approach changes the future values into present value. This approach considers such assessment techniques as present value, model for setting option prices, method regarding excess profits from several periods.

The entry data to evaluate the asset shall be measured according to a hierarchy that establishes the priority of the prices. This begins with level 1 considered the highest up to level 3 considered the lowest.

The reasonable value of a forest asset is based on its location and condition at the current moment (IAS 41, paragraph 9). Therefore, consequently, for example, the reasonable value of trees not cut down of a wood plantation is the price of the live trees in the corresponding market, bearing in mind the diameter of the trees and the wood density of the plantation for every cubic meter. (Fullana Belda & Ortuño Pérez).

In the analysis for establishing the reasonable value of the TEAK plantations, one must consider the level 3 hierarchy established by the IFRS 13.

- ***Level 3.-*** *When there is no active market for assessing the plantation, the company shall determine the market prices by applying net cash flows calculated at the present value for a 20-year period where an estimate is made of the exploitation. In the analysis, one must consider the estimated number of trees to be harvested, the plagues and death risks, the maintenance and exploitation costs. (Fullana Belda & Ortuño Pérez)*

It should be noted that an adult TEAK tree should have a 35-centimeter diameter and it should be between 2.25 and 2.30 meters high, so that it may be used as cleansed and sawed wood. In the thinning out performed in year 9, one obtains trees with diameters of 15.3 to 24.83 centimeters, which serve for square pieces. Those with diameters greater than 24.83 centimeters are used for carved wood. (Vega, Danny, 2013)

On the other hand, starting on January 1, 2015, the tax regulations of Ecuador are considering the accounting treatment and its tax effects through the registration of deferred taxes. This is according to the provisions of an unnumbered article following Article 28 of the Regulations for the Application of the Internal Tax System Law in its paragraph 7. It reads as follows: *"provides that income and costs listed in IAS 41 as well as initial recognitions and profit resulting from the measurement of biological assets as a result of biological transformations and others, are considered items not subject to income in the tax settlement"*.

Accordingly, in the tax period when the sale of the biological asset takes place, the income tax assessment will be made. Thus, one must consider the income from said transaction and the accumulated real costs that may be attributed to said transaction, for purposes of determining the tax base. Profits shall be taxable or losses shall be considered as nondeductible expenses when the optimum harvesting of the biological assets takes place. (IAS 12).

3. RECOGNITION AND MEASUREMENT IN THE ADOPTION OF BIOLOGICAL FOREST ASSETS

3.1 Initial measurement

IAS 41, paragraph 24 provides that the biological assets shall be measured at the historical cost when an agricultural activity may have undergone little biological transformations and the latter, in turn, are not important in the assessment of the Price, since it will not be capable of being reliably measured at a reasonable value. Accordingly, the costs incurred during the first 8 years are charged to the biological assets account (measured at the historical cost).

3.2 Accounting treatment of the property, plant and equipment (Land)

The rule does not apply for the accounting treatment of the lands used for the production of wood. Therefore, it is recorded in accordance with IAS 16 – Property, Plant and Equipment, except for the preparation of the land, which is considered within the initial *measurement* of the biological assets. (IAS 41, paragraph 25).

IAS 12 dealing with Tax on Profits will be applied, if benefits are obtained from the revaluation of the land. They will encumbered at the rate of 22% of Income Tax in Ecuador. It is considered a debt for deferred tax because it will be a tax payable until the amount of the asset is recovered.

The accounting process will consider the direct and indirect costs incurred in the establishment of the plantation, using as reference a hectare of TEAK, whose tree density is 1.111 trees per hectare.

3.3 Accounting treatment for the acquisition and sowing of biological assets

In the first year, agricultural inputs such as insecticides, herbicides and fertilizers to be used during the process are recorded in the Inventories account.

3.4 Accounting treatment for the maintenance of forest plantations

Within the wood production process, it is important to comply with the respective maintenance of the plantation since the early months, inasmuch as it is vulnerable to plagues and weeds. The costs incurred are registered in the biological assets account at the historical cost.

3.5 Maintenance in year 1

The different maintenance activities are described. These costs shall be registered in the biological assets account (measured at the historical cost), a temporary account that will accumulate costs up to the eighth year.

3.6 Maintenance at year 5

In year 5, thinning out works will be carried out. That is, the felling of trees that do not comply with the quality requirements. It is important to mention that there is no active market for commercializing the extracted trunks.

The TEAK plantation may be measured according to the market value in year 9. It is for this reason that the cumulative biological assets account (measurement at historical cost) is transferred to the biological assets account (measurement at reasonable value).

3.7 Subsequent measurement

According to Mancini (2016), the subsequent measurement of forest plantations is carried out when there is a transition from young wood to adult wood known as breaking point. That is, when exploitation of the trees begins. In addition, it is stated that it is not enough to say that the plantation has been accomplished in the first two years since its establishment. It is necessary that the plantation comply with certain characteristics in order to be exploited so that it may be reliably measured. In the case of TEAK, it may be measured in a reliable manner at the reasonable value since year 9. The reference used is the tree's diameter in centimeters. At that time, the tree should have as a minimum a 15-centimeter diameter, whose commercial value shall be US$ 70.00 per cubic meter[3].

[3] To calculate the cubic volume of wood produced, the factor applied is the form of the tree which is generally different for each species. In the case of TEAK, the factor 0.74.

Estimated amounts of Revenues from Thinning Out and Harvesting

Variables	AÑO 5 Raleo 1	AÑO 9 Raleo 2	AÑO 16 Raleo 3	AÑO 20 Cosecha
Nº Árboles	1.111	533	373	261
Diámetro	0,10	0,15	0,22	0,32
Altura	9,50	15,42	21,72	23,72
Factor	0,74	0,74	0,74	0,74
Mortalidad	0,20	0,00	0,00	0,00
% Raleo	0,40	0,30	0,30	1,00
Nº árboles	356	160	112	261
Volumen por árbol	**0,06**	**0,19**	**0,62**	**1,37**
Volumen/ha	**20,02**	**30,15**	**69,67**	**357,44**
Precio c/m3	- -	70,00	120,00	180,00
Total	**0,00**	**2.110,17**	**8.360,71**	**64.340,03**

Source: Forest Operator

3.8 Calculation of revenues from Thin Out 2 in year 9

$$\text{Number of trees} = (1111 - 222 - 356) * 30\% = 160 \text{ trees}$$

$$\text{Volume per tree} = \left(0.74 * \frac{0.15^2 * \pi}{4} * 15{,}42\right) = 0.19$$

$$\text{Volumen per hectare} = 355 * 0.19 = 30.15$$

$$\text{Income per hectare} = 35.15 * \$70 = \$2.110{,}17$$

Paragraph 62 of IFRS 13, refers to the application of assessment techniques such as the revenue approach when the market value is unknown, in order to evaluate the cash flows brought to the present value to which a risk-free discount rate will be applied, which is to be determined by the WACC[4] rate. This represents a minimum risk rate to evaluate the future net cash flow of an investment. In addition, it is known as the opportunity cost, given that the investor will refrain from buying now, to invest in a specific project in order to obtain interest in the future.

In the analysis of the WACC rate which is structured according to the cost of the debt and capital contributed by the stockholders, it is necessary to apply the rate of return, which the stockholders expect to receive from the investment in the entity.

[4] WACC: WEIGHTED AVERAGE COST OF CAPITAL

$$WACC = Ke \frac{CAA}{CAA+D} + Kd(1\text{-}T) \frac{D}{CAA+D}$$

Ke: Rate of opportunity cost of the stockholders(CAPM)

CAA: Capital contributed by the stockholders

D: Financial Debt acquired

Kd: Cost of the financial debt

$$WACC = 27{,}48\% * \frac{400{,}00}{400{,}00 + 12.911.742{,}00} + 9.59\%\ (1\text{-}22\%) \frac{12.911.742{,}00}{400{,}00 + 12.911.742{,}00}$$

$$WACC = 0.008 + 7.48$$

$$WACC = 7{,}49\%$$

3.9 Reasonable Value at year 9

The current value of the plantation in the fiscal year is US$ 30.605,97 and the book value of the biological assets has a balance of US$ 6.857,99. Therefore, the biological assets account (measured at reasonable value) is adjusted. It results in a profit of US$ 23.747,98. It will be encumbered as provided in the IAS 12 – Profit Tax at the rate of 22% of Income Tax in Ecuador, which value shall be considered as a deferred tax, since it will become effective when the biological asset is sold.

$$Present\ Value\ Year\ 9 = \ 1.494{,}87 - \frac{203{,}33}{(1 + 0.0749)^{1}} \ \dots \ \frac{62.138{,}18}{(1 + 0.0749)^{11}} = \$30.605{,}97$$

3.10 Measurement at reasonable value of year 10

In order to readjust the biological asset by December 31 of year 10, one must compare the reasonable book value of US$30,605.97 with the current value of the biological asset of US$31.403,48, and since there is a difference, an adjustment at reasonable value of US$797,15 will be recorded.

3.11 Revenues from thin out and measurement of reasonable value in year 16

In year 16, trees from the thin out activities were exploited. The revenues amounted to US$ 8.360,71 and the operation cost was US$ 639.31. At the end of the period, it was measured at the reasonable value, which resulted in a profit of US$ 3.674,87 by applying the tax regulations in Ecuador, whereby Regulation LORTI Art.28 (…) Number 7, provides that profits originating from the revaluation of biological assets shall be subject to the deferred tax.

3.12 Measurement of reasonable value at year 20

In period 18, the accumulated reasonable value was US$ 49.620,84, and the adjustment was made for a profit of US$ 3.945,31.

In year 19, the plantation maintenance costs are registered in the amount of US$ 256,31. At the end of the period, the biological asset is updated through present value cash flow, which resulted in US$ 53.566,16. At the beginning of the accounting period, the biological asset was recorded within the noncurrent asset, since it is a long-term property, but in year 19, it will be reclassified as a current asset since its realization shall take place in the next 12 months.

In year 20, the entity obtained, as a result of the harvest, 357 cubic meters of felled TEAK trees, whose reasonable value at the harvesting point was estimated at US$ 55.923,03 the cubic meter.

ASSESSMENT OF REASONABLE VALUE OF FELLED TREES	
	VALUE
Market value per cubic meter of felled trees	**64.340,03**
(-) Transportation costs	5.000,00
Other costs (Explotation license and circulation guide)	200,00
(=) Reasonable Value of trees at the point of harvesting	**59.140,03**
(-) Commissions of intermediaries and businessmen 5%	3.217,00
Reasonable value less sales costs of felled trees at the point of harvesting	**55.923,03**

It must be recalled that since year 9 until year 19, they were registered in the Assets and Liabilities accounts by way of Deferred Tax, which is a taxation and deduction at the time of making the tax reconciliation.

Net Cash Flow

YEARS	0	1	8	9	10	16	17	18	19	20	Total
INCOMES											
SALE											
Thinning 1	-	-	-	-	-	-	-	-	-	-	-
Thinning 2	-	-	-	2.110,17	-	-	-	-	-	-	2,110.17
Thinning 3	-	-	-	-	-	8.360,71	-	-	-	-	8,360.71
Harvest wood	-	-	-	-	-	-	-	-	-	64.340,03	64,340.03
TOTAL INCOMES	-	-	-	2.110,17	-	8.360,71	-	-	-	64.340,03	74,810.91
EXPENSES											
Establishment											
Land preparation	1.226,11	-	-	-	-	-	-	-	-	-	1,226.11
Planting	569,08	-	-	-	-	-	-	-	-	-	569.08
Subtotal Establishment	1.795,19	-	-	-	-	-	-	-	-	-	1,795.19
Maintenance											
Manual Labor											
Pest control	-	45,32	-	-	-	-	-	-	-	-	135.96
Cleaning	-	90,64	-	-	-	-	-	-	-	-	362.56
Crowning	-	335,67	-	-	-	-	-	-	-	-	335.67
Clearing	-	45,32	-	-	-	-	-	-	-	-	90.64
Fertilizer application	-	22,66	-	-	-	-	-	-	-	-	22.66
Herbicide application	-	475,86	-	-	-	-	-	-	-	-	1,903.44
Monitoring and control of plagues and diseases	-	11,33	-	-	-	-	-	-	-	-	45.32
Draining maintenance	-	22,66	22,66	22,66	22,66	22,66	22,66	22,66	22,66	-	430.54
Firebreak lines maintenance	-	11,33	11,33	11,33	11,33	11,33	11,33	11,33	11,33	-	215.27
Pruning and thinning	-	-	-	362,56	-	362,56	-	-	-	-	1,087.68
Inputs											-
Purchase fertilizer	-	33,33	-	-	-	-	-	-	-	-	33.33
Purchase herbicides	-	30,00	-	-	-	-	-	-	-	-	120.00
Subtotal maintenance	-	1.124,12	33,99	396,55	33,99	396,55	33,99	33,99	33,99	-	4,783.07
EXPLOITATION	-	-	-	-	-	-	-	-	-	1.703,84	1,703.84
TOTAL DIRECT COSTS	1.795,19	1.124,12	33,99	396,55	33,99	396,55	33,99	33,99	33,99	1.703,84	8,282.10
TOTAL INDIRECT COSTS	-	157,38	152,12	218,74	169,34	242,76	193,36	194,72	196,08	498,01	3,958.87
TOTAL EXPENSES	**1.795,19**	**1.281,50**	**186,11**	**615,29**	**203,33**	**639,31**	**227,35**	**228,71**	**230,07**	**2.201,85**	**12,240.97**
MARGIN	**(1.795,19)**	**(1.281,50)**	**(186,11)**	**1.494,87**	**(203,33)**	**7.721,40**	**(227,35)**	**(228,71)**	**(230,07)**	**62.138,18**	**62,569.94**
Accumulated costs	**(1.795,19)**	**(3.076,69)**	**(6.857,99)**								
Discount rate				7,49%	7,49%	7,49%	7,49%	7,49%	7,49%	7,49%	
Reasonable value				**$ 30.605,97**	**$ 31.403,48**	**$ 49.933,12**	**$ 45.951,71**	**$ 49.620,84**	**$ 53.566,16**	**$ 57.808,33**	
Profit / Loss				**$ 23.747,98**	**$ 797,51**	**$ 3.674,87**	**($ 3.981,41)**	**$ 3.669,14**	**$ 3.945,31**	**$ 4.242,18**	

Source: Forest Operator

4. CONCLUSIONS

- In Ecuador and the region the financial statements of regulated companied must be prepared according to the International Financial Reporting Standards (IFRS), or else, they are in the process of doing so. Within the international standard that regulates the recognition and assessment of biological assets, it is provided that they must be registered according to the reasonable value model. If in a given case the reasonable value of a biological asset in particular cannot be reliably measured, then the historical cost model should be applied.

- The application of the reasonable value is a change of paradigm, since it was not considered under the normal accounting rules. In the financial reports, the reasonable value model affords more valuable information for decisionmaking, as compared to the traditional historical cost model.

- In the case of the forestry sector, there is no evidence of the applicability of the reasonable value as provided by the IFRS, nor have they had experience with it. Likewise, the tax effect on the companies resulting from adjustments in said measurement have not been analyzed either. Only the historical cost model has been applied in recording and measuring these assets.

- As a result of these technical and tax uncertainties, companies have no appropriate interest, depending on the biological asset in question, in implementing technologies for reliably calculating the reasonable value without incurring in disproportionate costs or efforts. Recording biological assets simply at the historical cost, without previously evaluating a reasonable measurement, creates inconsistency in the application of international standards, thereby affecting the principle of comparability and losing the qualities of reliable and timely information.

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SEGMENTATION OF TAXPAYERS AS A **BALANCING STRATEGY OF THE ADMINISTRATIVE BURDEN** IN THE COMPLIANCE WITH TRANSFER PRICING DOCUMENTATION OBLIGATIONS

José Rafael
MONSALVE

SYNOPSIS

This article aims to show an approach that allows different jurisdictions to define guidelines for transfer pricing documentation by classifying taxpayers based on the definitions of related parties used in the transfer pricing regulations and balance the administrative burden in order to optimize the use of tax administration capacities and lighten the burden on smaller taxpayers, especially those obligated as consequence of a wide scope of application by the definition of related parties established in local rules.

CONTENT

1. Documentation obligations
2. Information returns and other measures of simplification and anti-evasion; Definition of related parties
3. Documentation approach considering the balancing of the administrative burden
4. Conclusions
5. Bibliography

THE AUTHOR

Transfer Pricing Economist considered by Euromonitor's Expert Guides as one of the World's Transfer Pricing Leading Advisors and invited as instructor and lecturer by various technical, academic, and sectorial institutions. He has advised corporations, companies and public entities, having the opportunity to participate in the analysis of transactions of various organizations in the following sectors: consumer goods, industrial products, financial institutions, services and energy. He was part of the firm PricewaterhouseCoopers during two decades. He is currently advisor to the General Directorate of Internal Taxation in the Dominican Republic on Transfer Pricing and International Taxation.

INTRODUCTION

As a result of the discussion emerging from the BEPS initiative Action Plan (*Base Erosion and Profit Shifting*), whose final report has updated the chapter V of OECD to transfer pricing guidelines to multinational enterprises and tax administrations (OECD guidelines), this agency has recommended the adoption of a standardized approach to documentation that is based on three (3) levels of documentation (*three-tiered approach*) which are: i) the Master File, ii) the Local File and iii) the Country-by-Country Report.

The OECD guidelines emphasize the administrative burden on the taxpayer in the preparation of the documentation, highlighting in paragraph 5.28 that taxpayers should not be expected to incur disproportionately high costs and burdens in producing documentation, and Tax Administrations should balance requests for documentation against the expected cost and administrative burden to the taxpayer of creating it. For its part, paragraph C. 2.1.2 of the United Nations Practical Manual on transfer pricing for developing countries, (hereinafter the UN Manual) establishes that a taxpayer should make reasonable efforts to reflect in its documentation an adequate transfer pricing analysis of its material transactions with associated, or related, enterprises in order to establish in good faith effort to apply the Arm's Length Principle. In addition, paragraph C. 2.2.3.5 of this handbook emphasizes that taxpayers should use prudent business judgment in determining the appropriate level of detail of the information to be supplied.

In addition, paragraph C. 2.2.3.7 of the UN Manual mentions that in considering the implementation of documentation rules, developing countries could decide to use a disclosure form, or information return, as an alternative to the list of required documentation contained in the Local File.

It can be seen in both the OECD Guidelines and the UN Handbook, a significant increase in the level of documentation required for the adoption of the three-tier approach of documentation mentioned and particular emphasis on the administrative burden that compliance implies for taxpayers.

Given the foregoing, this article proposes to define an approach that determines transfer pricing documentation obligations, considering a segmentation or classification of taxpayers, taking into account the scope and definition of related parties, allowing to balance the administrative burden, not only for the taxpayer but also for the Tax Administration. This approach should consider other aspects such as the capacities of the taxable person, including the business group to which it belongs, as well as its transfer pricing potential risks.

The implications of these documentation obligations, the use of information return and other measures of simplification and anti-tax evasion will be further elaborated below, subsequently the definition of related parties will be briefly reviewed, and as a consequence propose a documentation approach that contributes to balancing the administrative burden of these obligations and finally the respective conclusions of this article.

1. DOCUMENTATION OBLIGATIONS

As mentioned before, the OECD Guidelines recommend the adoption of a standardized approach for documentation based on three (3) levels of documentation:

1.1 Master File

As mentioned in paragraph 5.18 of the OECD Guidelines, this level of documentation is intended to provide the Tax Administration with an overview of the taxpayer's business group. It also has the aim of locating the business group's transfer pricing practices in their global economic, legal, financial and tax context.

This paragraph also mentions that in producing the Master File, including lists of important agreements, intangibles and transactions, taxpayers should use prudent business judgement in determining the appropriate level of detail for the information supplied. Likewise, as a self-assessment of sufficiency, for the purpose of elaborating the Master File, a piece of information is considered important if its omission would affect the reliability of the transfer pricing outcomes.

According to the OECD guidelines, the Master File must contain the following information:

Organizational structure:

- Chart illustrating the legal and ownership structure of the business group, as well as the geographical location of operating entities.

Business description (s):

- General written description of the Business group incluiding:
  - Important drivers of business profits;
  - Description of the supply chain of the group's five largest products and/or services offerings by turnover plus any other products or services amounting to more than 5 percent of the group's turnover;
  - List and brief description of important service agreements between members of the group, other than research and development (R&D) services, including a description of the capabilities of the principal locations providing important services and transfer pricing policies for allocating service costs and determine prices to be paid for intra-group services;
  - Description of the main geographical markets of the group's products and services that are referred in the second preceding point;
  - A brief written functional analysis describing the principal contributions to value creation by individual entities within the group, i.e. key functions performed, important risks assumed, and important assets used;
  - Description of important business restructuring transactions, acquisitions and disvestitures occurring during the fiscal year.

Business group Intangibles:

- General description of the global strategy of the business group for the development, ownership and exploitation of intangibles, including localization of principal R&D facilities and location of R&D management;
- List of intangibles or groups of intangibles of the business group that are important for transfer pricing purposes and which entities legally own them;
- List of important intangible agreements among identified associated enterprises, including cost contribution arrangements, principal research service agreements and licence agreements;
- General description of the group's transfer pricing policies related to R&D and intangibles;
- General description of any important transfer of interests in intangibles among associated enterprise during the fiscal year concerned, including the entities, countries, and compensation involved.

Business Group Financial Activities:

- General description of how the group is financed, including important financing agreements with unrelated lenders;
- Identification of any members of the business group that provide a central financing function for the group, including the country under whose laws the entity is organized and the place of effective management of such entities;
- General description of the group transfer pricing policies related to financing arrangements between associated companies.

Business group financial and tax positions:

- Business group's annual consolidated financial statements for the fiscal year concerned if otherwise prepared for financial reporting, regulatory, internal management, tax or other purposes;
- List and brief description of the group's existing unilateral Advance Pricing Agreements (APAs) and other tax rulings relating to the allocation of income among countries.

1.2 Local File

As mentioned in paragraph 5.22 of the OECD guidelines, the Local File provides more detailed information relating to specific intercompany transactions, namely that this report is focused on transactions with related parties carried out by the taxpayer. It also highlights that the information to be included in the Local File supplements the Master File and helps to meet the objective of assuring that the taxpayer has complied with the Arm's Length Principle in its material transfer pricing positions affecting a specific jurisdiction. It also emphasizes that where a requirement of the Local File can be fully satisfied by specific cross-reference to information contained in the Master File, such cross-reference should suffice.

The OECD guidelines specify that the Local File must contain the following information:

Local entity:

- Description of the management structure of the local entity, a local organization chart, and a description of the individuals to whom local management reports and the countries in which such individuals maintain their principal offices;

- Detailed description of the business and business strategy pursued by the local entity indicating whether the local entity has been involved in or affected by business restructurings or intangible transfers in the present or immediately past year and an explanation of those aspects of such transactions affecting the local entity;

- Key competitors.

Controlled operations:

For each material category of controlled transactions in which the entity is involved, provide the following information:

- Description of the material controlled transactions (e.g. acquisition of manufacturing services, purchases of goods, provision of services, loans, financial and performace guarantees, licences of intangibles, among others) and the context in which such transactions take place;

- The amount of intra-group payments and receipts for each category of controlled transactions involving the local entity (i.e., payments and receipts for products, services, royalties, interests, among others), broken down by the tax jurisdiction of the foreign payor or recipient;

- Identification of the associated companies involved in each category of related operations and the relationship among them;

- Copies of all material intercompany agreements concluded by the local entity;

- Detailed comparability and functional analysis of the taxpayer and relevant associated companies to each documented category of controlled transactions, including any changes compared to previous years;

- Indication of the most appropriate transfer pricing method with regard to the category of transaction and the reasons for selecting that method;

- Indication of which associated enterprise is selected as the tested aprty, if applicable, and an explanation of the reasons for this selection;

- Summary of the important assumptions made in applying the transfer pricing methodology;

- If relevant, an explanation of the reasons for performing a multi-year analysis;

- List and description of selected comparable uncontrolled transactions (internal or external), if any, and information on relevant financial indicators for independent enterprises relied on the analysis of transfer pricing, including a description of the comparable search methodology and the source of such information;

- Description of any comparability adjustments performed, and an indication of whether adjustments has been made on the results of the tested party, the comparable uncontrolled transactions or both;

- Description of the reasons for concluding that transactions were priced on an arm's length basis based on the application of the selected transfer pricing method;

- Summary of financial information used in applying the transfer pricing methodology;

- Copy of existing unilateral and multilateral APAs and other tax rulings to which the local tax jurisdiction is not a party and which are related to controlled transactions described above.

Financial information:

- Annual local entity financial accounts for the fiscal year concerned. If audited statements exist they should be supplied and if not, the existing unaudited statements should be supplied;

- Information and allocation schedules showing how the financial data used in applying the transfer pricing method may be tied to the annual financial statements;

- Summary schedules of relevant financial data for comparables used in the analysis and the sources from which the data was obtained.

Country-by-Country Reports

Paragraph 5.24. Of the OECD guidelines mention that the Country-by-Country Report requires aggregate tax jurisdisction-wide information relating to the global allocation of income, the taxes paid, and certain indicators of the location of the economic activity among tax jurisdictions in which the business group operates. In addition, this report requires a listing of all the Constituent Entities of the group for which financial information is reported, including the tax jurisdiction of residence, as well as the nature of the main business activities carried out by that Constituent Entity.

The information to be contained in the country-by-country report is as follows:

- Overview of the allocation of income, taxes and business activities by tax jurisdiction (Table 1):
  - Tax jurisdiction;
  - Revenue
  - Profits (or losses) before income tax;
  - Income tax paid (on cash basis);
  - Income tax accrued (current year);
  - Stated capital;
  - Accumulated earnings / withheld profits;
  - Number of employees;
  - Tangible assets other than cash or cash equivalents.

- List of all the Constituent Entities of the business group included in each aggregation by tax jurisdiction (Table 2):
  - Entities resident in the tax jurisdiction;
  - Tax jurisdiction of the organization or incorporation, if different from tax jurisdiction of residence;
  - Main business activity (ies).

2. USE OF INFORMATION RETURNS AND TAX SIMPLIFICATION / ANTI-EVASION MEASURES

2.1 Use of information returns

The use of disclosure forms or information returns has been a commonly adopted practice in Latin American jurisdictions and has represented the main tool for the risk assessment of transfer pricing by Tax Administrations. Historically, the usual practice has been for taxpayers to provide through these returns, on a given date, the relevant information regarding the transfer pricing analysis carried out by the taxpayer. Depending on the results of the assessments and risk analysis, the Tax Administration could request additional information and/or its transfer pricing study to the taxpayer, considering that the common practice in these jurisdictions was the obligation to prepare the study but to be presented to the Tax Administration upon request only. However, it should be noted that in several jurisdictions, it has become mandatory to present the transfer pricing study on a given date.

With regard to the transfer pricing information return, Ortega, Monsalve and Pinedo (2015) mention that the information usually required is varied and includes the name of the company or individuals, related legal entities, the tax identification number (Tax ID) of the taxpayer and the related company, country of domicile of the related entity, and type of relationship, among others.

These authors also mention that in these returns, it is required the details of the transactions carried out with related companies such as the type of operation (income, costs or expenses), quantity, date of the transaction, invoice number, customs documentation or declaration (in case of exports) that supports the transaction, currency used, amount of the transaction. In addition to these information, some information returns require to include information from the valuation analysis part of the transfer pricing study, such as the valuation method, the arm's length range (interquartile) of transactions, and the price or amount of the compensation (margin) established by the company in the transaction.

2.2 Safe harbors

Protection regimes or safe harbors are mechanisms that seek to simplify and sometimes exonerate from the application of transfer pricing regulations a given group of taxpayers or types of transactions. In this regard, paragraph 4.102 of the OECD Guidelines stipulates that a safe harbor is a regulation that applies to a particular category of taxpayers or transactions and that exempts them from certain obligations imposed by the general transfer pricing regulations of a country.

This type of regime has been questioned in the past because in the search for simplification it could encourage taxpayers to move away from the Arm's Length Principle. In this regard, the OECD guidelines in paragraph 4.96 mention that while safe harbor regimes could simplify compliance with transfer pricing and its administration, they could cause fundamental problems that could have potentially perverse effects in pricing decisions of companies dealing with controlled transactions.

Notwithstanding the foregoing, as mentioned in paragraph 4.97 of the OECD guidelines, these regimes have generally been applied to smaller taxpayers and/or less complex transactions. They have been assessed favorably by both taxpayers and Tax Administrations that have indicated that the benefits exceed the concerns about their application when these regimes are carefully defined and when the proper efforts are made to avoid problems that could arise from poorly considered protection regimes. The benefits of using the protection scheme mentioned in paragraph 4.105 of the aforementioned guidelines can be summarized in:

- Simplifying and reducing compliance costs;
- Certainty for the taxpayer;
- Efforts and resources redirection of the tax administration towards more complex and risky taxpayers and/or transactions.

For its part, paragraph 4.110 mentions the adverse consequences of safe harbor regimes which are summarized below:

- Inconsistency with the Arm's Length Principle;
- Risk of double taxation or non-taxation;
- Opens roads to inappropriate fiscal planning;
- Could generate concerns about fairness and uniformity.

2.3 Threshold

Some jurisdictions have established threshold parameters for their transfer pricing documentation obligations in their regulations. In this regard, paragraph 5.9 of the OECD Guidelines stipulates that documentation requirements should be kept within the framework of reasonableness and focused on material transactions.

Both paragraph 5.32 of the OECD Guidelines and paragraph C. 2.2.3.4. of the UN Handbook emphasize that not all transactions that occur between associated or related companies are sufficiently material to require complete documentation. In addition, this paragraph of the above-mentioned UN Manual emphasizes that the metrics of materiality can be considered in relative terms (e.g.: percentage of income, costs, equity, among others) or absolutes (amount). Another aspect that highlights is that they consider rules that give small and medium taxpayers exemptions for the presentation of documentation or limit the amount of documentation requested from those entities.

2.4 Definition of related parties

The OECD Guidelines in defining the Arm's Length Principle refer to article 9 of the OECD Tax Agreement model, which in turn derives that two companies are considered related parties (associated enterprises) when:

a) An enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State; Or

b) The same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State.

Just as the Arm's Length Principle has been widely adopted and included in the legislations of different countries, in this same way, the provisions of article 9 of that Convention have served as a basis in the different jurisdictions to establish the definition of related or linked parties. For its part, the UN Manual, at the end of paragraph B. 8.3.2, mentions that the degree of control as a parameter for the application of transfer pricing legislation has indeed been left to local law.

The common practice has been to take as a basis the criteria of management, capital and control as a starting point and to provide more detail in aspects such as that percentage of shareholding would imply that two entities are considered related parties by concept of capital, as well as Certain types of tax payers such as permanent establishments, agents or exclusive distributors and other control measures such as significant percentages of acquisition or sale by a single customer or supplier as the case may be, among others.

3. DOCUMENTATION APPROACH CONSIDERING THE BALANCING OF THE ADMINISTRATIVE BURDEN

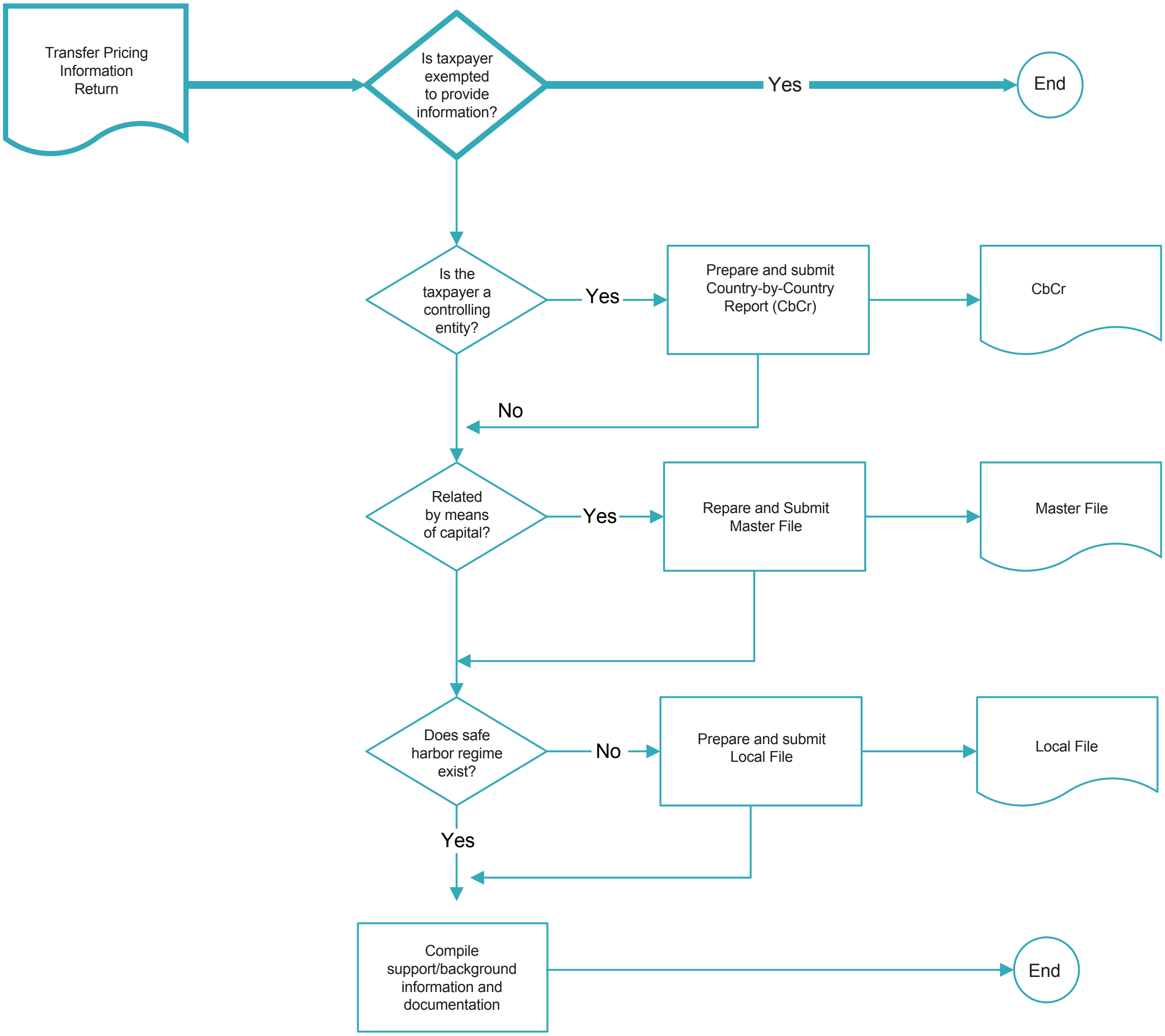
In view of the increasing complexity of business models and transactions derived from business groups, as well as the increasing administrative burden involved in compliance with documentation obligations, including those resulting from the Action 13 Report of BEPS, a key aspect of balancing the administrative burden arising from these obligations is to consider the different types of taxpayers derived from the definition of related parties in each jurisdiction, as well as their administrative and contributive capacity.

Developing countries, for example, have their particularities, among which we can highlight the characteristics of their economies, tax system, type of most common intercompany transactions and scope of transfer pricing rules, which may present variants, such as the application of these rules to domestic transactions, i.e., between taxpayers domiciled in the same jurisdiction.

Considering the foregoing, large taxpayers, who usually are part of large business groups with operations at the international level should be subject to most of these obligations, while smaller taxpayers to whom apply definitions of related parties more closely related to control elements explicitly defined in local legislation and/or with transactions amounts significantly lower than those of the large taxpayers for whom this type of obligations have been defined, should only comply with minimum documentation requirements.

The following diagram shows the documentation obligations considering the three-tiered approach contained in the OECD Guidelines, the taxpayer segmentation and the respective balancing of the administrative burden:

Diagram N°1: Proposed documentation approach for balancing the transfer pricing documentation obligations


Transfer Pricing Information Return
Is taxpayer exempted to provide information?
Yes
End
Is the taxpayer a controlling entity?
Yes
Prepare and submit Country-by-Country Report (CbCr)
CbCr
No
Related by means of capital?
Yes
Repare and Submit Master File
Master File
Does safe harbor regime exist?
No
Prepare and submit Local File
Local File
Yes
Compile support/background information and documentation
End

Source: Created by Author

As mentioned earlier, a practice commonly adopted by the Latin American countries has been the inclusion of the obligation to submit an information return as part of the transfer pricing obligations. Despite the fact that, as seen in the introduction, the OECD Guidelines and the UN Manual emphasize the decrease in the administrative burden on the taxpayer, to the point of recommending the selection between the use of such returns or the local file, the balancing approach of the administrative burden proposed in this article is based on preserving the obligation to file the transfer pricing information return and that it continues to represent the fundamental tool of the Tax Administration to ensure the taxpayer's compliance.

The foregoing does not rule out that the different jurisdictions make efforts to evaluate the relevance of the information currently requested in these returns or to establish mechanisms for simplifying the submission process.

It should be noted that this type of return has been an important tool for the risk assessment and analysis of the Tax Administrations and the decrease of the administrative burden is not only a need of the taxable person but also of the Tax Administration, so any documentation approach that decreases the administrative burden on the taxpayer should not represent a significant additional burden to the tax administration, at least in the long run.

As can be seen in the diagram, under this approach, if the local regulations establishes a level of threshold that is not exceeded by the taxpayer, the taxpayer's obligation may be limited to the information return of the transactions carried out during the fiscal year and the Tax Administration would request additional information only if necessary.

In the event that the taxpayer is the controlling entity of the business group to which it belongs, this entity should prepare and present the country-by-country report, as well as the master and local files. Where the definition of related parties that applies to the taxpayer's transaction is by shareholding (capital), this entity must present the Master File. In principle, this file should have been prepared by the controlling entity or parent company of the business group. In addition, the taxpayer must prepare and present the Local File.

Where the taxpayer's transactions are with entities that are not related parties through shareholder participation, the taxpayer must prepare only the Local File. Another alternative is to have defined safe harbor regimes for transactions or industries that apply to the taxpayer and therefore, it would be exempt from submitting the Local File. Such mechanisms would contribute to further reducing the taxpayer's administrative burden.

For all the cases mentioned above, the taxpayer must have the information and background documentation to support what is informed in both the information return and the various files and reports indicated.

The following table illustrates the documentation obligations under the previously proposed documentation approach:

Table N° 1:
Documentation obligation
by type of taxpayers

Type of taxpayer	Information Return	Country-by Country Report	Master File	Local File	Safe Harbor
Below threshold levels	✓				
Controlling entity	✓	✓	✓	✓	
Related by means of Capital (non-controlling)	✓		✓	✓	
Related by means different to capital	✓			✓	
Related by means of control and under safe harbor regime	✓				✓

Source: Created by Author

As can be observed, situations may arise that constitute an administrative burden on taxpayers, and, from a cost-benefit view point, it would not be a priority for the Tax Administration to monitor these taxpayers, considering the opportunity cost of resources for the review of a taxpayer's transaction or business. These situations have been addressed by some jurisdictions including exemptions in their regulations. In essence, however, the obligation should be more oriented to the nature of the transaction and not to its magnitude or amount. An alternative to solving these situations without deviating much from the nature of the transaction, giving a touch of pragmatism to compliance and subsequent review is the use of safe harbor regimes.

Gimbel Lewis (2012) considers the benefits of safe harbor regimes to simplify compliance, reduce compliance cost, and tax certainty for taxpayers. For Tax Administrations, she considers that the only type of benefit noted is the resource rationalization but such mechanisms can increase the level of compliance among small taxpayers that may otherwise believe their transfer pricing practices will escape scrutiny.

As mentioned by Gimbel Lewis (2011), the limited resources of the Tax Administration would be more effectively deployed by focusing on large taxpayers rather than on small taxpayers. She also mentions that because it is not feasible for the Tax Administration to audit most of the small taxpayers and, since small taxpayers have trouble understanding or complying with intricacies of the current rules or, simply sidestep them through ignorance or design, there must be considerable amounts of revenue left on the table.

Given the foregoing, safe harbors could represent a fundamental factor in the simplification process, an increase in the level of compliance and a decrease in the administrative burden of both the tax agency and the taxpayer, especially when the local regulations contemplate in the definition of related parties different variants of control situations, as well as domestic transactions.

The treatment of the aforementioned definitions of related parties may result in a substantial increase in the basis of taxpayers subject to these obligations, but time and resources are required to verify the taxpayers compliance and the result of this activity may not necessarily be translated into a significant increase in the tax collection.

From the taxpayer's point of view, the broad definition of related parties, in the absence of simplification mechanisms such as safe harbors, would result in a taxpayer having to meet extensive documentation obligations despite not carrying out transactions with companies that are not part of the same business group.

4. CONCLUSIONS

Even if these documentation obligations may appear very extensive and cumbersome, they should not necessarily be applied in full to all taxpayers if an adequate taxpayer segmentation is implemented, and if the administrative burden of taxpayer is balanced at normative level.

A proper segmentation of the taxpayer should consider, among other aspects, the following:

- Particular circumstances of each jurisdiction;
- Risk assessments;
- Scope of the obligation;
- Definition of related parties.

The segmentation and balancing of the administrative burden can contribute to optimize the use of the Tax Administration resources when auditing the taxpayers. Likewise, the administrative burden would be allocated to the taxpayers taking into account their management capacity and their tax capacity.

The taxpayers within the different defined segments should organize themselves to manage in the most efficient way the fulfillment of the documentation obligations that correspond to them.

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MACROECONOMIC CONVERGENCE AT SADC **WHAT ARE THE CHALLENGES POSED WITHIN THE FRAMEWORK** OF INTRAREGIONAL TRADE?

Alano **SICATO**
Miguel **CARVALHO**

SYNOPSIS

The main purpose of this article is to provide research elements that may be useful to the readers of the Inter-American Center of Tax Administrations (CIAT) as regards the process of creation of Free Trade Zones, which are very frequent in the current world, although especially with respect to the Regional Integration of SADC.

This article will endeavor to explain, among other issues, the possible harmonization and convergence of macroeconomic policies within the framework of the regional economic integration processes, by evaluating the nature of the incentives that lead the countries to become part or not, of the different regional economic areas. The purpose of the article is likewise to evaluate the possible challenges and opportunities related to this process.

CONTENT

1. Introduction
2. Regional Economic Integration Concept
3. Phases of the process of creation of a regional economic integration zone
4. Potential profits from adherence to the Free Trade Zones
5. Potential losses from adherence to the Regional Economic Integration Zones
6. “Protectionism” as an argument against adherence to the Free Trade Zones
7. Analysis of the macroeconomic convergence of SADC countries
8. Conclusion

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INTRODUCTION

General Objetive

- Analyze the possible harmonization and convergence of the macroeconomic policies within the framework of regional integration of the SADC.

Specific Objective

1. Understand the economic fundamentals in relation to the concept of International Economy and Regional Economic Integration.

2. Understand the different phases of a regional economic integration process.

3. Expound theories regarding the challenges of Regional Integration of the SADC.

During the past decades, the world economy, faster than could have been anticipated, has experienced different ways of commercial cooperation agreements within the framework of international trade contracts. These agreements have led the countries to create the so-called Regional Economic Integration Zones, that currently proliferate throughout the world, some of them being; SADC (Southern African Development Community)[1], MERCOSUR (Southern Common Market), ANSA (Association of Southeast Asian Nations) and the EU (European Union).

The emergence of these Free Markets and/or Customs Unions has been defended by several authors, as one of the main levers for the speedy dissemination of the economic globalization phenomenon in the past four decades, thereby allowing the exponential increase in the volume of commercial exchanges between countries and an accelerated spread of the new technologies almost throughout the entire world. In fact, the regional economic integration has been understood as an agreement in the light of international trade, which allows a specific group of countries not only to eliminate the main barriers of international trade among the members of said group, but also to define common commercial policies.

As for the Southern African Development Community (SADC), it is a regional economic and political block, established in 1992, and formed by 14 countries from South Africa, specifically; South Africa, Angola, Botswana, Democratic Republic of Congo, Lesotho, Madagascar, Malawi, Mauritius, Mozambique, Namibia, Swaziland, Tanzania, Zambia andy Zimbabwe, with headquarters in the city of Gaborone (the largest city of Botswana).

According to the Treaty of the Southern African Development Community, the objectives of the regional organization are, among others, the following:

1. To promote dealing in products and services among the member countries;
2. Reduce poverty of the population of all the member countries and improve the quality of life;
3. Maximize the use of the natural resources of the region;
4. Promote the sustainable growth of the countries of the block;
5. Promote peace and good political relations in the region, by acting to avoid conflicts and wars;
6. Socioecnomic and political cooperation in the region;
7. Seek common solutions for the main challenges of the region;
8. Reduction and unification of customs tariffs and import and export rates in the commercial relations between the member countries.

Accordingly, it endeavors to explain the possible harmonization and convergence of the macroeconomic policies in the regional economic integration processes, by evaluating the nature of the incentives that motivate the countries to integrate themselves or not in the different regional economic areas.

The sequence of our work should consider, first of all, the regional economic integration concept, beginning with the idea that the countries must reduce or eliminate the commercial barriers in the intrarregional transactions, as well as the adoption of a unified commercial policy

[1] See "Treaty of the Southern African Development Communit", available at http://www.sadc.int/documents-publications/show/4171 , last seen on 24.08.2017.

in relation to third parties. Thereafter, we will consider the determinant reasons that motivate the countries to decide in favor of their integration to a regional economic zone, highlighting the political, economic, defense and security fundamental reasons. We will continue with a brief discussion of the phases necessary for the implementation of an economic zone, since, as we understand, it is a complex process that involves difficult negotiations between the governments of the different participating countries, until arriving at a full integration of their economies. Finally, we will conclude by analyzing the advantages and disadvantages of an eventual economic integration and the theoretical model that would render viable the need for a macroeconomic convergence with a view to achieving the purposes of an economic integration zone, using as case study to support our position, the macroeconomic convergence of the SADC countries in the period between 2003 and 2013.

1. REGIONAL ECONOMIC INTEGRATION CONCEPT

The Regional Economic Integration concept is related to the elimination or reduction of trade barriers between countries of a given region. However, in its primary phase, which merely deals with free trade agreements, these countries are free to autonomously determine their commercial policies.

Thus, in the sphere of economic sciences, it is understood that the regional economic integration theories essentially arose to avoid the economic losses and distortions that occur whenever the countries decide to apply the traditional free trade barriers in their international economic relations, (Piggot 2006)[2].

In this way, in order to correct the distortions that are generally derived from the application of restrictive commercial policies, the countries that are part of a regional economic integration zone are obliged to adhere to the different models of international trade contracts, thereby allowing ever more opportunities to the emergence of the regional economic integration phenomenon, that have been recently occurring almost everywhere, with over 400 regional international trade agreements held until 2011 in harmony with the World Trade Organization (WTO) / GATT (Amini, C. 2011).

It must be noted that the World Trade Organization was officially established on January 1, 1995 through the Marrakech Agreement in substitution of the General Agreement on Tariffs and Trade (GATT), which entered into force in 1948, following the Second World War. This is, up till now, one of the most complete multilateral agreements in the international trade sphere.

1.1 Why do countries join the regional economic integration zones?

Some academicians, such as Baldwin (2004), are in favor of the idea that the main motivation behind the emergence of the regional economic blocks was to guarantee and protect political and military interests, although economic motivations are the most evident and explain the recent integration trend of more member countries in these areas. Essentially, there are two types of motivations for countries to adhere to the regional economic integration zones, in particular, of a political and economic nature.

1.2 Political Reasons

Specific governments or countries recall the need to take into account regional conflicts and promote national security, as one of the main objectives for adhering to the regional economic integration zones.

The reasoning behind this argument is that the provision of certain public services such as peace and national defense cannot be efficiently guaranteed without a certain degree of military intervention, Schiff (2003) and Winters (2003).

The key premise of this argument is that the environment for the success of a specific country is to a great extent dependent on the national security guarantees. It is thus understood by Schiff (2003) and Winters (2003), which explains why the regional economic integration zones may be used as a safe weapon for mitigating political and military conflicts between neighboring countries. It is essentially on the basis of this argument

[2] Piggott and Cook (2006, pag.32-40) ”International Business Economics”.

that Angola, although not having yet ratified the Free Trade agreements of the SADC is a member with full rights of this Free Trade Zone.

1.3 Economic Reasons

The economic reasons that frequently lead governments to join the Regional Economic Integration Zones are related to two great components, in particular: the potential profits from Free Trade and the positive effects of Direct Foreign Investment in the national economy.

The idea that Free Trade is beneficial is linked to the economic benefits that result when the regional economic blocks, voluntarily decide to remove the trade barriers (tariffs and rates) among the members of this block. According to Krugman and Obstfeld (2011), in a free trade system, the regional economic blocks may obtain enormous economic profits, such as specialized labor, economies of scale, economy of the agglomeration, expansion of the markets, greater competitiveness and significant reductions of the prices of goods and services available.

It is admitted that these positive externalities lead to an increase of the consumer's surplus and significantly increase the production in the economy thus promoting economic growth, Alizadeh (2011). However, regardless of all these possible benefits derived from free trade, the latter also brings with it some economic distortions and welfare losses.

Nevertheless, with respect to direct foreign investment, according to Piggott (2006) and Amini (2011), it may also be considered a good incentive for countries to join the regional economic blocks due to its positive impact in the promotion of employment, expansion of the markets and dissemination of the technology within the regional economic integration zone, which, accordingly, improves the performance of the economy as a whole.

2. THE PHASES IN THE PROCESS OF CREATION OF A REGIONAL ECONOMIC INTEGRATION ZONE

Although there may not be sufficient evidence to verify that the phases of the process of creation of the regional economic integration zones necessarily follow an obligatory logical sequence, even thus, some academicians have been persistent in reiterating its progressive nature, and especially, adjusted to the economic, social and cultural conditions that vary from country to country, as stated by Alves da Rocha.

Rocha (2008)[3] suggests that Customs Unions must be subsequent to the creation of the free trade zones, judging from their level of complexity. He also notes that "the free trade concept is linked to the elimination of trade barries (tariffs and rates) among the countries that are part of a specific regional economic zone, although those countries are free to determine their commercial policies with the nonmember countries of this zone". For example, NAFTA, in North America, free trade agreement between the United States, Canada and Mexico and SADC (Southern African Development Community) itself.

However, in this stage of the economic integration process the members countries of the commercial blocks maintain autonomous commercial policies for the rest of the world, which generally results in trade deflation, due to the differences in tariff policies among the different countries that comprise the Regional Economic Integration Zone.

Trade deflation occurs when two or more countries form a Regional Economic Integration Zone with the application of non-homogenous tariffs to non-member countries of this regional block and, accordingly, one of the member countries reduces the amount of the tariff applied to the non-member countries to channel for itself the exclusive import of specific products that may subsequently be commercialized in another member country, generally at speculative prices Piggott and Cook (2006)[4].

[3] (Rocha 2008, pag.81-84) "Introducción a la Economía Internacional e Integración Regional"

[4] Piggott and Cook (2006, pag.90-91) "International Business Economics".

Thus, in order to avoid losses resulting from trade deflation, the countries tend to take the next step which is the creation of a Customs Union.

With the creation of the Customs Union, possible losses resulting from trade deflation disappear and thus a more advanced stage of the process of creation of the Regional Economic Integration Zone is achieved, which involves not only the elimination of trade barriers (tariffs and rates) but also the adoption of a single customs tariff and common trade policies (tariffs and rates) for the nonmember countries of the regional block.

However, the creation of the Customs Union also results in the development of a Regional Block wherein, in addition to the freedom of circulation of goods between the participating countries, there is a single customs tariff to regulate commercial relationships with third countries and the joint negotiation of any agreement with other nonmember countries ", Rocha (2008)[5]. For example: the European Community.

In this way, the members of the regional blocks may further improve their economic integration process if, following the creation of the Customs Union they gradually evolve toward the creation of Common Markets which, in addition to the elimination of the tariff barriers, they anticipate the free circulation of capital and production factors. In other words, there is a single labor market within the Regional Economic Integration Zone such as the European Community.

Thereafter, the Regional Economic Integration Zone may evolve toward Economic Unions that fundamentally involve the use of a single currency within the Regional Economic Integration Zone and the harmonization of fiscal and monetary policies within this area. Finally, they give way to Political Unions or the creation of political institutions with supranational powers. For example: the European Community / European Parliament.

SADC's Regional Economic Integration Zone is in the first stage of the Economic Integration process, dealing oly with the Free Trade agreements, although with the intention to evolve toward a Customs Union by 2016. In the meantime, it should be noted that in relation to the Free Trade agreements this study has limitations for measuring, in fact, the level of participation of Angola and the Democratic Republic of Congo in this matter.

3. POTENTIAL GAINS IN JOINING THE REGIONAL ECONOMIC INTEGRATION ZONES

Currently, the analysis of the potential gains to be obtained by joining the regional economic integration areas have been mainly attributed to Viner (1950) and Meade (1955), who have conducted several studies dealing with the creation of Regional Economic Integration Zones. Therefore, the gains indicated may be summarized as follows:

1. Recent theories on regional economic development have indicated that the traditonal trade barriers, such as rates and tariffs, have resulted in improvements in international trade efficiency and, more so, have also contributed to the reduction of differences in the sphere of new technologies.

2. The new trend of the Regional Economic Integration Zones (contrary to what occurred in the sixties and seventies, when they were established according to the argument of the imports substitution strategy) is mainly based on the search for "homogeneous" economic growth models within the member countries of the regional blocks.

3. The establishment of the new regional economic integration zones has contributed to mitigate the discrepancies in the income levels and the quality of life of the citizens of the different member countries of the regional blocks.

Thus, according to Piggott and Cook (2006)[6], the greater the trade barrier or tariff restrictions among the countries, the lower the profits from international trade. The justification of this argument is that tariff barriers deviate international trade destinations, thereby resulting in the loss of welfare for the consumers.

[5] (Rocha, 2008. Pag. 82) "Introducción a la Economía Internacional e Integración Regional".

[6] Piggott and Cook (2006, page 51)"International Business Economics".

4. POTENTIAL LOSSES WHEN JOINING THE REGIONAL ECONOMIC INTEGRATION ZONES

4.1 Loss of Autonomy in determining the fiscal and monetary policies

The first consequence generally resulting from the creation of Customs Unions is the loss of autonomy for determining one's own tariff policies vis-a-vis third countries. This is always a consequence since it is very difficult to harmonize a Common Customs Tariff with the tariff policy of each member of the regional block. Thus it is impossible for the countries to create effective macroeconomic policies adapted to their specific realities, Rocha (2008).

Evidences

- One evidence of this argument may be verified in the empirical study conducted by Forouton (1993) on Regional integration in the countries of Sub-Saharan Africa. According to Forouton, "the structural characteristics of the economies of the countries of Sub-Saharan Africa, the permanent important substitution strategies, the persistent inequalities in the distribution of costs and benefits derived from economic integration, have prevented compliance with the economic integration purposes in the countries of this region ", Thirlwall (2006)[7].

- Vamvakidis (1999) prepared a case study with 109 countries comprising the 18 free trade zones, in the 1950 to 1992 period and concluded that the impact of the rate of growth of the countries with the greatest growth, with respect to the other member countries was negative, Thirlwall (2006)[8].

- This evidence is not applicable to the SADC member countries since it is only a Free Trade Zone and not a Customs Union.

4.2 Trade deviation

According to Piggott and Cook (2006), the creation of Regional Economic Integration Zones show two opposite trends which increase trade within the Customs Union, but which also reduce the volume of international trade with countries outside the Customs Union. This is due to the fact that the member countries of the Regional Economic Integration Zone import goods from other member countries of the block, which were previously imported from nonmember countries, even when eventually, the member countries (have higher prices), are less efficient than the nonmember countries.

In this way, the countries of the Customs Union only benefit from the fact that they are not subject to the commercial restrictions (tariffs and rates) and the nonmember countries are penalized only for being outside the regional economic block, even though they may be more efficient, in terms of production, than the member countries.

Evidences

- SADC – A clear evidence of the deviation of trade may be observed at the level of SADC's intrarregional commercial relations, wherein exports from South Africa to the region and the other member countries account for 19% of total exports and of this total, 13% goes to other member countries of the Southern African Customs Union (SACU). It must also be noted that the SADC countries import more than 70% of its products from South Africa itself, with Swaziland buying 92.9% thereof, Schuck (2009).

- Another flagrant deviation of trade may be seen in the Economic Community of West African States (ECWAS) created in 1975, it being evidenced that the volume of trade between the member countries of the block is less than 10 per cent of total exports, Thirlwall (2006).

5. "PROTECTIONISM", AS ARGUMENT AGAINST ADHERENCE TO THE REGIONAL ECONOMIC INTEGRATION ZONE

There are two main protectionist arguments related to the adherence to the Regional Economic Integration

[7] (Thirlwall,2006. Page 527) " Growth and Development"

[8] (Thirlwall,2006. Pag.527) " Growth and Development"

Zones. These are the arguments which Angola and the Democratic Republic of Congo have exhaustively explored for the nonratification of the Free Trade Agreements of SADC's Regional Economic Integration Zones.

5.1 Strategic Commercial Policy

The strategic commercial policies are a paradigmatic example of the arguments recurrently presented by the Government of Angola for not adhering up till now to the free trade agreements of SADC's Regional Economic Integration Zone.

These policies are particularly adopted by those countries that are still in a very embryonic phase of their economic development process. This is the situation of the countries which, for one reason or another have not managed to develop their productive structures and give them the necessary strength to compete with similar foreign industries. These countries thus sought, through adequate restrictive commercial policies, to reinforce the internal market with the traditional argument of *protection of the growing industry or local employment*.

Evidences

The validity of the arguments relative to the promotion/protection of the growing industry which have been used by Angola and the Democratic Republic of Congo in order not to adhere to SADC's Free Trade agreements, have already been evidenced in the following studies:

- An evidence of this argument may be verified in the empirical work by (See Ha-joon Chang, 2002), who concluded that the countries of Europe, North America and Scandinavia developed their industries based on the strategies involving the "protection of the developing industry ", Thirlwall (2006)[9].

- Evidences contrary to this argument were also observed in several empirical works such as those by Young (1991), Matsuyama (1992), and Galor and Mountford (2008) who likewise reached the following conclusion: "The strategy regarding the protection of the developing industry may lead the countries to specialize themselves in industries without any potential for promoting long-term economic growth, since the static profits of trade may be reflected in their long-term dynamic costs ", Acemoglu (2009)[10].

5.2 Increase of Tax Revenues

It is also very common that those countries that find themselves in a stage wherein they are in urgent need of investing in infrastructures such as roads, bridges, schools, hospitals and other basic infrastructures capable of promoting economic growth, their governments resort to restrictive commercial policies that may increase the rates of import taxes and expand the tax base in order to increase the Government's revenues and thus be able to finance specific public expenditures, which otherwise the governments could not incur.

6. ANALYSIS OF MACROECONOMIC COVERGENCE BETWEEN THE SADC COUNTRIES, FROM 2003 TO 2012, WITHIN THE FRAMEWORK OF ECONOMIC POLICY HARMONIZATION

As has already been stated in this article, one of the main purposes of SADC's regional economic integration is the improvement of the macroeconomic performance of the member countries, through the improvement of the socioeconomic indicators, thereby allowing the struggle against poverty and improvement of the quality of life of the people in this region. Thus, if every country of the region improves its economy, it shall compete in order to confirm the economic growth of the per capita GDP at the level of the SADC countries, as anticipated by Robert Solow (1957) in his economic growth model. It should be noted that there is support to this matter in the Macroeconomic Convergence Memorandum adopted in 2002[11], wherein there is a definition of the criteria and mechanisms through which the States must endeavor to apply economic stability policies for the purpose of aligning their economies.

[9] (Thirlwall,2006. Pag.543) " Growth and Development"

[10] (Acemolglu, 2009. pag.680) "Modern Economic Growth".

[11] See "THE SOUTHERN AFRICAN DEVELOPMENT COMMUNITY MEMORANDUM OF UNDERSTANDING ON MACROECONOMIC CONVERGENCE" Available at en: http://www.sadc.int/files/6513/5333/7917/Memorandum_of_Understanding_on_Macroeconomic_Convergence2011.pdf, last seen on 24-08-2017.

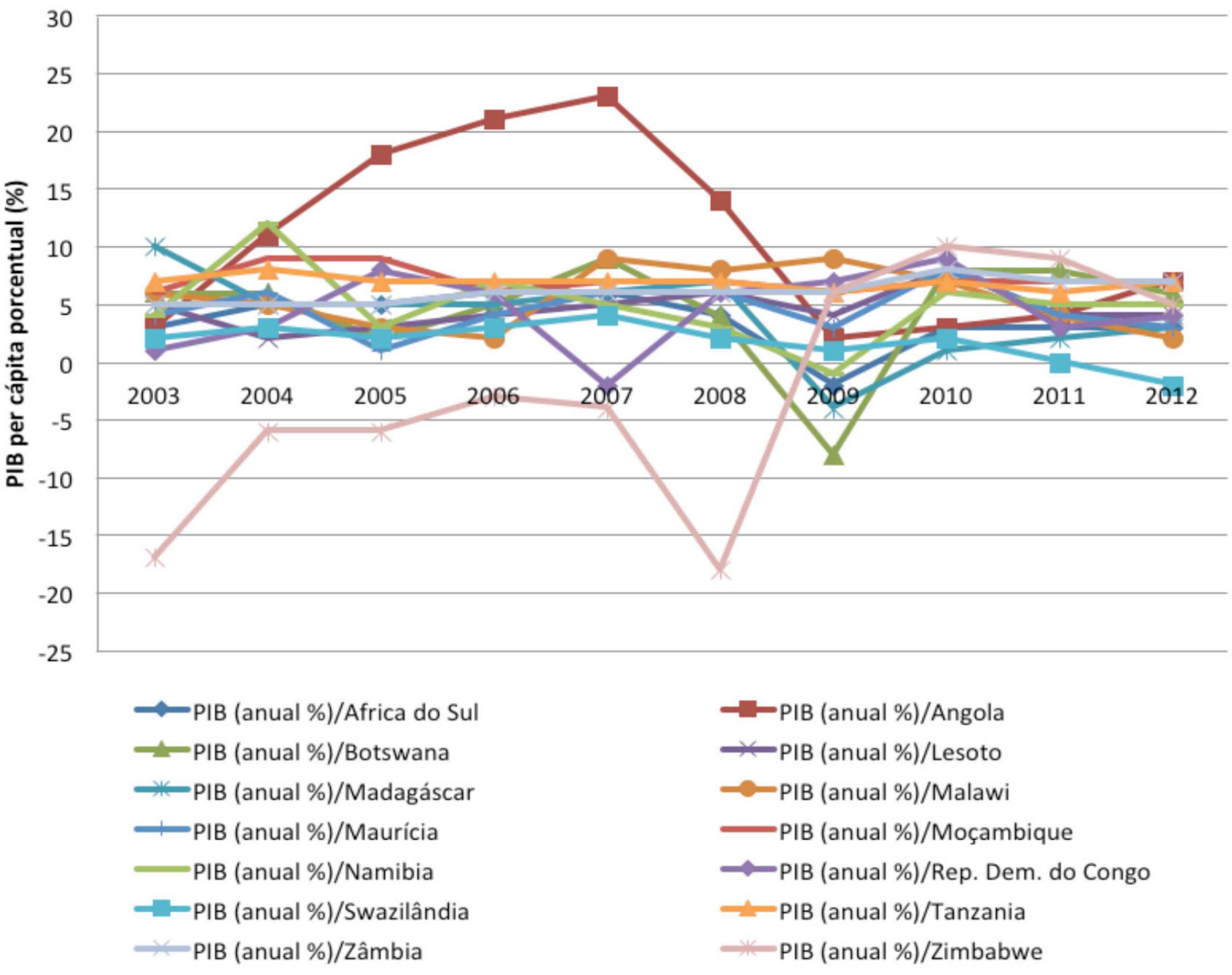
The illustrative graph of the SADC member countries shown below, confirms that the economic growth of the countries of the region has been converging. This convergence is mainly due to the importance of the role of investment in the economies of the region and to the fact that, as stated by Solow (1957), the countries with the highest rate of savings, may accumulate more capital and within short term, grow more than the countries with a lower rate of savings.

For example, the graph shows that the per capita GDP of Angola, although it was the one with the greatest growth, at the level of the SADC region between 2003 and 2008, with an average growth of 15%, nevertheless, in the past 5 years, (following the 2008 economic crisis) the mean went down to 5.32%.

On the other hand, the graph also shows that from 2003 to 2008, Zimbabwe was the country of the region with less growth, with even negative growth rates throughout this period. However, after 2008, through the improvement of its macroeconomic performance, its per capita GDP increased positively, thereby converging not only toward the average growth of Angola's per capita GDP, but also toward the average growth of the region's per capita GDP.

In this way, the graph confirms that within the framework of harmonization of the economic policies of SADC member countries of the region, Robert Solow's (1957) convergence hypothesis began to be verified.

Graph 1
Macroeconomic Convergence among the SADC Countries



Source: World Bank statistics /2013.

7. CONCLUSION

Through this article we may understand that, in spite of the economic incentives, which are the main motivation for adherence to the Regional Economic Integration Zone, this also depends, to a great extent, on the political and military interests to be considered by the adhering States.

From this article it also follows that the potential economic gains obtained through regional economic integration, in particular, may be counteracted by the potential economic losses derived from the economic integration process. In this way, such variables as the loss of autonomy in the determination of fiscal and monetary policies and the trade deviation phenomenon may generate severe economic distortions, capable of placing at stake the main purposes for the creation of the Customs Unions. Economic convergence is essential as a common purpose of the member countries.

However, with respect to the creation of the SADC's Regional Economic Integration Zone devised by the African leaders, the latter, in spite of the difficulties, has advanced, thereby confirming that within the framework of harmonization of the economic policies of the SADC member countries of the region, Robert Solow's (1957) convergence hypothesis was confirmed after 2010. Nevertheless, even though each one of the 14 member States through its Indicative Regional Development Strategic Plan set goals within the sphere of public debt, inflation and deficit, the performance of the majority of the economies of the region does not yet correspond to that established.

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PROSPECTIVE IN THE TAX ADMINISTRATION COLLECTION STRATEGY

Giancarlo
SOTIL GALLEGOS

SYNOPSIS

This paper discusses the use of prospective in the collection strategy, identifying the megatrends and strategic variables to build ideal scenarios for the future, also evaluating the opportunities. In Peru, it is essential to combat and eliminate tax evasion, as well as the lack of culture regarding compliance with tax duties. The proposed research will contribute to the generation of a prospective strategic planning application model for officials in the areas of strategies that correlate the influence of prospective planning and its impact on internal tax collection, proposing solutions to problems related to low tax collection.

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INTRODUCTION

Tax administrations today use technology to facilitate compliance and control of tax obligations through electronic books, issuance of electronic vouchers, using Point of Sales (POS) or fiscal memory to issue electronic vouchers. The penetration of the Internet and greater access to broadband allow tax administrations to enroll a greater number of taxpayers, so they are no longer just large and medium-sized enterprises, but also small businesses and independent workers who are compelled to enter the virtual world.

In Peru, taxpayers have recently been incorporated into the new Simplified Single Regime (NRUS, acronym in Spanish)[1] to use from the 01.08.2017 sales terminals (POS) for payment and issuance of the electronic payment voucher. Although it is optional in a first stage, in a not very long period of time it would be obligatory, as is the case of the independent workers, who from April 1, 2017 emit only electronic proofs of payment. These changes are breaking paradigms, since technology and the Internet are in continuous development and are part of the day to day, to the point that the current economically active generations have the characteristic of being technological and those that come within few years, were born with the technology in the hands, taking into account also that each time, more businesses or enterprises use Internet platforms as business model.

However, having the taxpayers' income information allows the tax administration to develop a tax revenue account, as well as the elaboration of a draft or pre-return for the taxpayer to accept the determination of tax carried out by the tax administration. This determination is normally accepted, but not timely paid. The business delinquency rate accumulated in the year 2016 was 17.6% for the business income tax and VAT figure representing 7,280 million of soles or US $2,240[2] million of dollars (Results 2016, report N° 003-2017-SUNAT).

The tax administration has developed strategies to obtain payment, which are depending on the profile of the taxpayer, from inductive communications to the generation of electronic records of enforced collection to carry out embargoes in bank accounts and registrable assets, among other measures, always with due anticipation, since, the more the precautionary measures are delayed, the less option to recover the tax debt, due to the planning of the taxpayer not to pay the debt, by disposing of its assets through intermediaries, companies or entities constituted in the country or abroad.

We should wonder if having the electronic information to create a tax account and make available pre-returns, as well as doing a series of activities to maximize the collection of the tax will generate the *desired profitability*, i.e. to reduce the delinquency rate and increase the tax pressure. This maximization of results, is more similar to the *operational efficiency* defined by Porter (2009) as a better use of inputs to obtain a higher profitability, but not a strategy of collection growth, and in consequence, growth of the tax pressure. Therefore it is vital to build other more disruptive paths or strategies that generate greater productivity to increase the tax revenues.

1. USE OF BANKING SERVICES

In Peru, since the year 2004 with the Law 28194[3], Law for fighting against evasion and for the formalization of the economy, it was decided that for the business expense to have tax effect, one must use banking payments[4] from operations greater than S/3, 500 Soles or US $1,000 American dollars. Recently, from this year 2017 with Legislative decree 1258[5], individuals who generate work income (payroll worker or self-employed) have the incentive to request electronic payment vouchers and obtain 3 UIT[6], of additional deduction, which will be added to the fixed 7 UIT with which it already counts and which are considered as non-taxable minimum income.

[1] The New Simplified Single Regime is a small business regime created since the year 2004. In this regime, income must not exceed S/96 000 a year equivalent to US $ $29 538 USD (exchange rate S/3.25 per U.S. dollar).

[2] Exchange rate S/3.40 per U.S. dollar.

[3] Published The 26.03.2004.

[4] Means of payments are considered unbanked to deposits in account, debit or credit card charges, among others.

[5] Posted on 8.12.2016

[6] UIT is the tax revenue unit, whose value is S/4 050 soles or US $1 246 (exchange rate S/3, 25 per U.S. dollar).

The condition for the deduction is that the payment is made through means of payment via bank, no matter the amount, i.e. the threshold starts from below. This was also another paradigm shift. The interesting aspect about this model is that by regulatory standard it is possible to extend the demand for electronic payment vouchers to other independent professions or economic activities[7].

This model foresees that 1.5 million of people who previously had no incentive to request electronic vouchers do so now to obtain an additional deduction which is 3 UIT, contributing not only to obtaining income information for the Control of the tax administration, but also to the banking of the suppliers who will obtain better opportunities of credit and economic development as part of their financial inclusion. Now, and if the non-taxable minimum income that is currently 7 UIT without any sustenance will be supported by electronic voucher and paid with means of payment services would the effect not be greater? I'm sure it would, and it would depend on a change at the level of law.

Currently, if there is no financial history, the interest rates provided by financial and non-financial institutions are quite high. That is why Peru from 2015 has implemented *the National strategy of financial inclusion as a tool to promote social inclusion and economic development*. One of the goals, is that for the year 2021, 75% of the adults in the country own an account in the financial system. In 2014 the percentage was only 29%. Activities include the use of high-and low-range mobile phones, implementing the electronic wallet that will leverage the massive use of cell phones in the country through an interoperable platform (Multi-sector Financial Inclusion Commission, 2015). To this end, banking would operate as an impulse to this policy by adding an opportunity to increase the collection. Porter (2009) pointed out that the correct role of the state is to be a catalyst and stimulator, encouraging companies to raise their aspirations to advance to higher levels of competitiveness, creating the environment for companies to achieve competitive advantages.

2. THE PROSPECTIVE IN STRATEGY

Indacochea (2016) indicated that prospective is the study of future scenarios and the main merit of the scenarios is not to predict the future, but to contribute to provide answers to develop future strategies by activating the strategic planning processes that promotes the necessary changes to reach the desired future, such as the increase of the collection and the tax pressure. According to the Organization for Economic Development Cooperation (OECD, 2017) the collection of Peru for the year 2015 in relation to its gross domestic product (GDP) was 17.1%, being below the average of the countries of Latin America and the Caribbean (22.8%) and far lower than OECD countries (34.3%).

The current environment has been called the fourth Industrial Revolution for the great advances in science and information and communication technologies (ICTs), so the prospective strategic planning is presented as an analytical tool for decision making that will impact the tax collection to the extent that strategies are aligned with the megatrends that contribute to improve the tax collection processes. Glenn (2013) pointed out that a global challenge for the coming decades is: (a) the development of new technologies; (b) Global convergence of ICTs through an interconnected world with broadband access and artificial intelligence; (c) policies more responsive to global perspectives to achieve a future vision by pursuing higher goals through strategies that seek to solve poverty.

In this sense, the tax administrations that rely on ICTs would be guiding their collection processes to be simpler and more efficient, facilitating also the control of tax compliance. The world is increasingly interconnected and tax administrations worldwide are no exception. The OECD seeks to improve country strategies by means of recommendations and mechanisms for the exchange of automatic tax information that contribute to an increase in tax revenues, so it is appropriate to take advantage of the surrounding opportunities to increase the sources of information to mitigate tax evasion, increase the collection and, consequently, improve the standard of living of the population. In this way, the tax pressure could increase significantly if the technology is used, as

[7] For the year 2017 the economic activities that allow the additional deduction of expenses are: rentals of real estate; Interest in first home mortgage loans; As well as expenses with independent professionals such as physicians, dentists, lawyers, architects, engineers, systems and computer analysts, nurse, nutritionist, sports coach, interpreters and translators, photographer, obstetrician, Psychologist, medical technologist and veterinarian.

well as the automatic exchange of information between tax administrations, as well as information of public and private local institutions.

3. OPPORTUNITIES

It is necessary to take advantage of the interconnectivity (big data) that is developed with the public entities and other foreign tax administrators. This tool is part of the disruptive technologies; they facilitate the exchange of information that will serve as a tool for tax collection (Bitar, 2014). Likewise, the bankarization of operations through means of payment and the issuance of electronic vouchers are processes that support the tax collection, which ends up being an online statement with sales information, just so that the taxpayer just has to accept and pay his taxes through credit or debit cards on account (CIAT, 2014).

However, we can make the most of the technology using the Blockchain concept, in which customer and supplier participate (contributors) united by the information of the payment medium in a operation in where the banking institution of the means of payment and the tax administration intervene, as the recipient of the information, issuer of the electronic voucher and generating the *tax account*, understood as information generated from tax facts viewed by taxpayers. However, the disruptive opportunity to seize, with today's technology, is that the bank retains the income tax and VAT and deposits it in the public treasury account at the time that the payment occurs, all in a single moment and in all the operations that should use the banking services.

In this sense, the use of banking services for all operations that generate tax expenditure is another opportunity that must be used to make the withholdings of income tax and VAT at the time of payment through a means of payment via bank. For such purposes, considering the State policy of financial inclusion, the use of banking services by companies must be compulsory regardless of the amount, as well as in the case of individuals who can now consider an additional deduction of 3 ITU if their expenses are recorded on a bank account. In the first lines of this article it was mentioned that companies can already opt to make use of Point of Sales (POS) to emit their electronic vouchers, which demonstrates that the technology is present and in continuous progress, and the computer systems are more adaptable to achieve simplification and efficiency.

In the case of the additional expenditure of 3 UIT for individuals generating work income, it was also mentioned that the model was interesting because it could be regulated and be scaled to other professions and economic activities, such as those that use Internet platforms to provide services or products. This means that, with the simple payment of the client to the supplier through a bank payment, the tax would be collected through the bank withholding, in addition to generating the information of income and expenses to the supplier and client respectively, advancing even to a scenario of elimination of the annual tax return, since the payment of the tax at the time of payment, can be considered as definitive and cancel the tax debt. Under this scenario, the default rate would be zero (0) in operations that generate tax expenditure.

Another opportunity to take advantage of globalization is to improve the connectivity with taxpayers, through new virtual technologies supported by a larger broadband, as well as the artificial intelligence that can be supplied in the future with some tax administration activities, such as tax orientation.

4. THREATS

It is better to face a threat with a position of fortitude. At the global level there are natural disasters, social conflicts, falling prices of minerals that affects developing countries with great mining activity, so that a profitable or productive collection generates the necessary resources to achieve an adequate fiscal sustainability that generates opportunities for the inclusive economic development.

On the other hand, political instability is a threat that discourages investment and the potential for economic growth. In that sense, the OECD (2017) in the integrity study for Peru noted that the country's socio-economic growth is affected by poor governance and corruption that harms the integrity of public institutions, favoring an unstable environment in which particular economic interests prevail at the expense of the common good, both favored by the low demand for accountability and transparency in expenditure.

Now, and if the threat is confronted with the use of the big data as a strength to detect unjustified assets and intermediaries, societies or entities, the effect could be positive by discouraging the acts of corruption of public officials and private individuals. We will then move on to detail the steps of a prospective planning method.

4.1. Prospective strategic planning method

The first thing to do is to ask a question, in our case related to the collection, as for example, how can the tax administration be strengthened to increase the tax revenue to 2027?

To answer this question, we evaluate some *key drivers* or strategic variables that allow to build the ideal scenario that we want to achieve, i.e. the vision. Once identified the Key drivers proceeds to a *Delphy* data collection, which is basically an open survey to distinguished experts in international taxation, both national and foreigners.

The questions for the Delphy survey for this work are as follows:

1. What are the driving factors of change?
2. How could digital trade be controlled?
3. How to detect accounts to avoid and identify money laundering?
4. How to raise awareness of the importance of tax collection?

The following table 1 shows a list of megatrends, which should be taken into account as the Delphy questionnaire is applied.

Table 1: Megatrends

Information and communication Technology (ICT) and operational technology (TO)	Cllimate change	Governance, Interoperability (Big Data)
	Life expectancy	
	Expansion of the middle class	Convention on mutual Administrative Assistance in fiscal matters, BEPS
Demographic- Urbanization process	Global economic power Shift (BRICS)	Citizen Empowerment and Authentic democracy
	More sensitive global policies	Scarcity of water resources
Demographic- Population growth	Scientific advances, biogenetic, disease reduction	Shared values reduce conflicts
	Combating international organized crime, asset laundering, international tax fraud, drug trafficking	Sustainable development to meet higher demands for safe energy
Women who can help change the situation of humanity	Corporate Social Responsible (CSR) - Ethical market economies	Economic globalization - Increased cross-border business and foreign investment

Adapted from “15 global challenges for the upcoming decades Open Mind by Glenn,” by Glenn J. C, 2013 (https://www.bbvaopenmind.com/articulo/15-desafios-globales-para-las-proximas-decadas1/?fullscreen=true) and “megatrends: An analysis of the state Global by National Strategic Thinking center of Peru, “by Eclac, 2016 (http://www.ceplan.gob.pe/documentos_/megatendencias-un-analisis-del-estado-global/).

Table 2 shows the results of the Delphy survey administered to experts in international taxation of the International Monetary Fund and eight managers of the Tax Administration from areas of strategic development and operational areas with more than 20 years of experience.

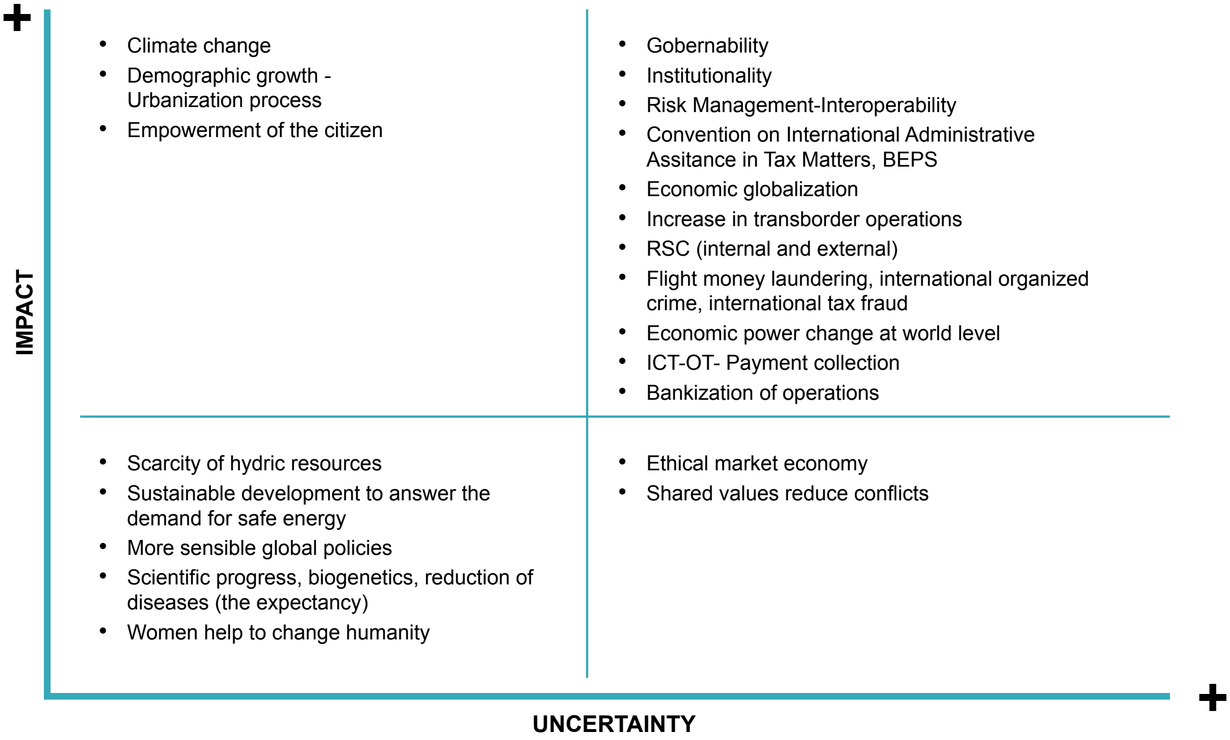
Table 2: Results of the Delphy Survey

QUESTIONS	DELPHY ANSWERS	MEGATRENDS
What are the driving factors of change?	Redefine processes and procedures of the tax administration to be agile as a startup.	Governance
	Collaborators as drivers of change.	Corporate Social Responsibility (CSR)
	Training for collaborators.	CSR
	Tax culture-creating tax awareness	CSR
	Risk consolidation	Governance
	Consistent information	Convention on Mutual Administrative Assistance in Tax matters
	Eliminate tax Benefits	Governance
	Training for audit planning of transnational corporations	Convention on Mutual Administrative Assistance in Tax matters
	Facilitating the taxpayer	Information and communication technology (ICT) and operational technology (TO)
	Predictability	ICT and Operational Technology (TO)
	Timely information management-improving the structure of information	ICT and Operational Technology (TO)
	Segmentation of taxpayers	ICT and Operational Technology (TO)
	Assets Traceability	Governability, Interoperability, Convention on Mutual Administrative Assistance in Tax matters
	Promote progressiveness in revenue	Governability-CSR
	Computer Infrastructure reengineering	ICT and Operational Technology (TO)
	Soft Skills Training	CSR
	Control of large net worth	Combating asset laundering and international tax fraud
	Sources of external information	Convention on Mutual Administrative Assistance in Tax matters
	Net worth Consolidation Model	Combating asset laundering
	Closing cycle to ensure the presentation and quality of tax returns	Governance
	Elimination of Power Islands	Governance
How could digital trade be controlled?	Through payments	ICT
	Through bank transfers	ICT
	Tax Information exchange agreements	Economic globalization
	Financial Information exchange agreements	Economic globalization
	Exclusive use of payment methods (banking)	ICT
How to detect key accounts to avoid and identify money laundering?	Taxpayer risk profile	ICT
	Tracking of individual and related assets information	ICT
	Assets traceability	ICT
	Bank Secrecy Lifting Information report	ICT-Fighting the laundering of assets
	Programs of control of non-justified assets increase	ICT-Fighting the laundering of assets
	Business Capital Origin Analysis	ICT
How to raise awareness of the importance of tax collection?	Shared Task Tax Administration-Government	Governability-CSR
	Efficient use of resources-quality service delivery	Governance
	Services that facilitate tax compliance	ICT
	Combating tax evasion and tax avoidance	Governability-TICs
	Tax culture	CSR
	Disseminate the good use of money from the collection	CSR

Note. Responses of the questionnaire of interviews applied to eight managers of the tax administration pertaining to the areas of development of strategies and centralized operative areas with more than 20 years of experience and an expert officer in taxation International Monetary Fund

Then, Figure 1 presents an impact and uncertainty matrix, which is produced on the basis of the megatrends, noting that the megatrends in the upper right quadrant are the ones that will contribute with a greater impact on the tax collection.

Figure 1. Impact and uncertainty matrix



- Climate change
- Demographic growth - Urbanization process
- Empowerment of the citizen

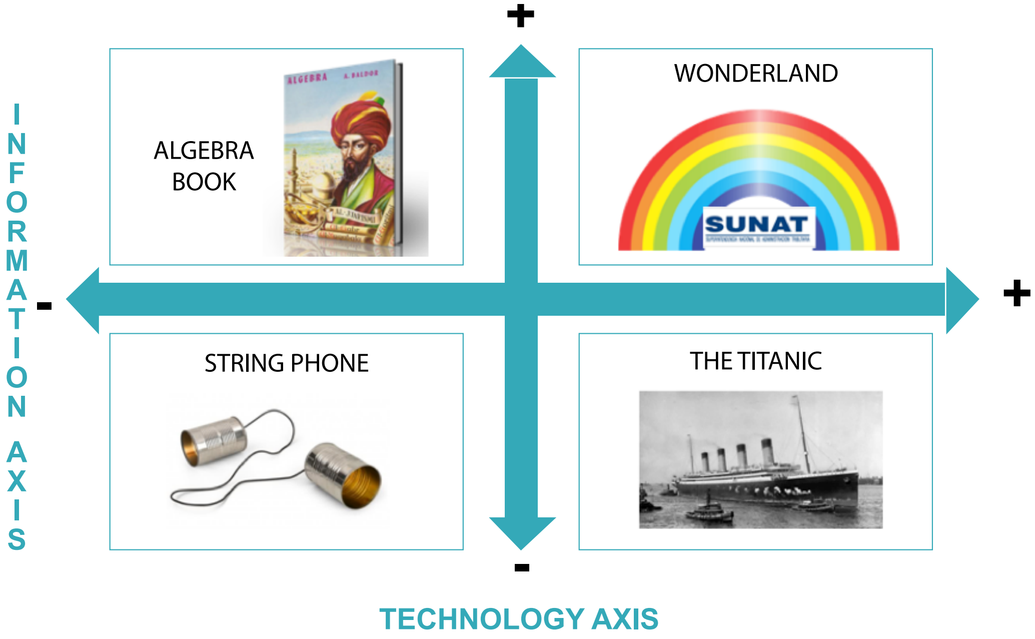
- Gobernability
- Institutionality
- Risk Management-Interoperability
- Convention on International Administrative Assitance in Tax Matters, BEPS
- Economic globalization
- Increase in transborder operations
- RSC (internal and external)
- Flight money laundering, international organized crime, international tax fraud
- Economic power change at world level
- ICT-OT- Payment collection
- Bankization of operations

- Scarcity of hydric resources
- Sustainable development to answer the demand for safe energy
- More sensible global policies
- Scientific progress, biogenetics, reduction of diseases (the expectancy)
- Women help to change humanity

- Ethical market economy
- Shared values reduce conflicts

Wade (2012) noted that scenarios are built by linking value-driven variables to the organization. From the review, in the case of the tax administration, the variables of information and technology can be mentioned as critical variables or boosters of value. Figure 2 shows four scenarios for the tax administration represented in an image for each quadrant as shown below.

Figure 2. Scenarios for tax administration



Now, developing each stage. The Wonderland scenario is a scenario that has (+) technology and (+) information. This scenario can be detailed in the following way:

- Context of stronger governance with emphasis on improving processes and risk management in strategic planning, a tax pressure greater than 30% is achieved.
- Solid institutionality in values and autonomy.
- Orientation and work with a focus on risk generation with greater availability of information by interoperability (*Big data*).
- Members of the Convention on Mutual Administrative Assistance in Tax Matters to exchange tax and financial information with more than 113 countries, incorporation of the BEPS Actions to avoid the profits shifting and erosion of the tax base.
- Companies in the Financial System report movements and balances of accounts.
- Country with sustained economic growth aligned to the context of economic globalization.
- High level of specialization to supervise and control the increase in cross-border businesses.
- Corporate Social Responsibility as a fundamental strategic part (internal and external social responsibility).
- High level of specialization to fight asset laundering and international tax fraud.
- All operations performed through means of payment via bank.
- A collection model designating the withholding agent to the financial system entity so that at the time of the "payment" to the supplier of the good or service the tax amount is withheld (definitive payment and cancellation by eliminating the tax return).

For its part, the *Baldor* scenario, has (-) technology and (+) information and can be expressed as follows:

- The climate change context around the world drives the tax administration to use taxes with an extra tax function through environmental taxation.
- Demographic growth and urbanization process. Cities grow and there are all kinds of applications in the network with a greater user experience when using *augmented reality*, but the tax administration without improvements in its computing and technological architecture is not in the capacity to detect the new virtual businesses and generate risk.
- Citizen empowerment increases the ability for citizens to make their rights prevail and be a more active protagonist in the social, political and economic issues of the country, so it will be closely following the actions of the Tax administration if it is not focused on the major breaches of transnational corporations and people with high net worth imbalances.
- More information through interoperability, national and foreign financial information and tax exchange cannot be used without the appropriate technology to generate risk, so the tax pressure will remain below 20%.

On the other hand, the *string phone* scenario has key Factors in (-) technology and (-) in the information and can be expressed as follows:

- There will be a shortage of water resources and greater demand for safe energy due to climate change. Without technology and without information the tax administration will not be able to implement an environmental taxation system that contributes to sustainable economic growth.
- The tax administration will not be able to contribute to more sensitive global policies, if it is not capable of implementing a segmentation of taxpayers for a more equitable progressive taxation and risk generation in the appropriate cases.
- Scientific advances in biogenetics and disease reduction will increase life expectancy, coupled with an increase in the middle class, the tax administration cannot generate risks if it has no information and technology to detect new sources of Income.
- A tax administration without technology and without information will not be able to increase the collection for a better redistribution of income, so there is a greater increase of women who contribute to the change of the situation of the humanity in management positions. The tax pressure is kept below 18%.

Finally, the Titanic scenario has key factors of (+) technology and (-) information and can be expressed in the following way:

- Without information, the tax administration does not generate risk despite having good computer and technological infrastructure. The collection does not increase, it does not contribute to the fiscal sustainability of the country and the tax pressure remains below 20%.
- Ethical market economy with social responsibility increases due to the economic deficiencies facing the country due to the lack of participation of the State in the redistribution of income.
- Shared values reduce conflicts and generate greater global economic growth, investments are increased, new business with technology, but without information the tax administration does not generate risk and the facilitation to the taxpayer alone does not increase the tax pressure

The next step is to raise a strategic vision of the tax administration to 2027 based on the outcome of the prospective analysis. For the purposes of this work, the following vision is presented:

In 2027, the SUNAT is the tax and customs administration with the best technology in the region, applying ICTs to all processes from the first contact with the taxpayer to the collection of taxes applied to the payment. Efficient, with a tax pressure greater than 30%, reliable, with a chain of virtual services, simple, efficient and transparent, facilitating the international trade, completely interconnected with the public institutions, companies of the system Financial and foreign tax administrations worldwide. Socially responsible, applying fair procedures with its staff and stakeholders. Honorable, because it contributes to the elimination of corruption and laundering of assets in Peru and the world.

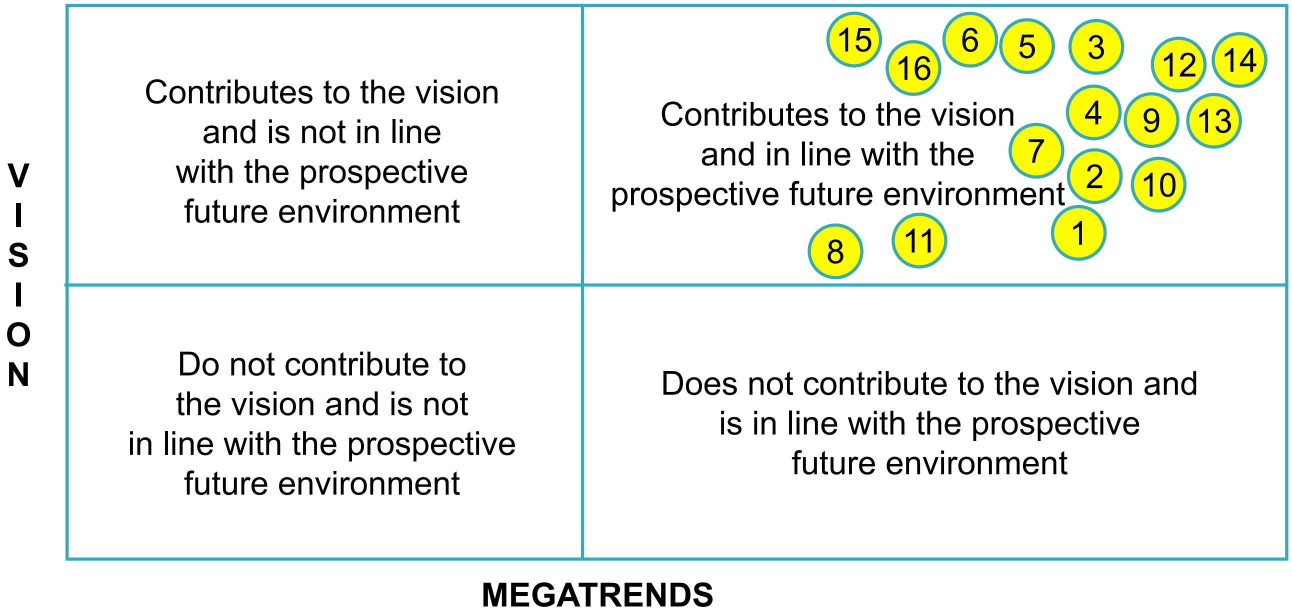
Finally, the method for the elaboration of strategies culminates with the valuation of these based on whether they are within the vision proposed, the level of impact and relation with the megatrend identified, and then be expressed in table 3: Evaluation of Strategies and Figure 3 Strategy evaluation matrix.

Table 3: Evaluation of strategies

STRATEGIES	VISION	IMPACT	MEGA-TREND
1. New model of income tax collection and VAT via withholding in the means of payment by the bank or financial institution.	5	5	5
2. Compulsory use of means of payment in all operations that sustain expenditure.	4	5	5
3. Implement tax non-compliance variables with the tax and financial information of the automatic exchange of the Convention on Mutual Administrative Assistance in Tax Matters (it gathers more than 113 countries including tax havens).	5	5	5
4. Implementation of the BEPS recommendations to avoid the Profits shifting and erosion of the tax base.	5	5	5
5. To strengthen interoperability by signing new agreements and addenda with public institutions, guaranteeing the quality and availability of information.	5	4	5
6. Companies in the national financial system report movements and balances of passive accounts.	5	5	5
7. Implement the model of assets consolidation to identify the traceability of the information of the individual net worth and its links for the control of unjustified assets increase and laundering of assets.	5	5	5
8. Implement a tax Money utilization report in communications with the taxpayer after the tax payment.	4	4	4
9. To propose the development of the value of the tax culture at all educational levels.	5	5	5
10. To expand the network of agreements to avoid double taxation because Peru starts an investment process abroad.	4	3	5
11. Implement tax non-compliance variables from internal sources to detect operations that have not been declared or have not used bank payment methods.	4	3	4
12. To implement taxes with an extra fiscal function through environmental taxation.	5	4	5
13. Increase the storage capacity of the information (data storage in DNA) and modernization of the computer infrastructure.	5	5	5
14. To strengthen the specialization of the auditors for the control of transnational and related companies, as well as for controlling individuals with high net worth.	5	5	4
15. Incorporate Artificial Intelligence (AI) into virtual services that facilitate tax compliance.	5	4	5
16. Incorporate technology to reduce the time of dispatch of goods (online) and control of the smuggling and transport of controlled goods (chemical inputs) through the use of satellites and drones.	5	4	5

Note. The rating scale is 1 = very low; 2 = low; 3 = medium; 4 = high; 5 = Very high

Figure 3: Strategy Evaluation matrix



Contributes to the vision and is not in line with the prospective future environment

Contributes to the vision and in line with the prospective future environment

Do not contribute to the vision and is not in line with the prospective future environment

Does not contribute to the vision and is in line with the prospective future environment

5. CONCLUSIONS

1. Completing this work has allowed to develop an analysis with a prospective approach. Critical thinking was used to project the National Superintendence of Customs and tax Administration in a global environment to 2027 where the future has great impact and offers opportunities to seize.

2. The application of the prospective approach has made possible to identify new ways to achieve the effectiveness in the processes, to generate confidence in the taxpayer, to increase the tax pressure, to apply new practices of corporate social responsibility, among others, aligned directly with the megatrends. The most important of them are technology, access to information and alliances and information of the new international conventions of automatic exchange of information and compliance with the BEPS Action Plan.

3. Globalization and technology have proven to be the key megatrends for the efficient development of tax collection. Their accessibility and good management will benefit the control and the payment of taxes, avoiding the laundering of assets and contributing to the increase of the tax pressure.

4. Megatrends as motor forces represent a global view of current trends.

5. The identification of scenarios has allowed to visualize clearly the wonderland scenario as the ideal to achieve a tax pressure goal for the 2027 greater than 30%.

6. Achieving the ideal scenario will only be possible by applying strategies related to activities that generate greater profitability with absolute availability of information using ICTs and the latest technologies.

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