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2022 Colombian Tax Reform – Some Preliminary Remarks on U.S. FTC Issues Arising from the SEP Rule and the Corporate Residency Test

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During 2022, a new Colombian Tax Reform was approved by means of which several new provisions, as well as amendments to pre-existing rules, were introduced into Colombian tax legislation. The 2022 Colombian Tax Reform was part of an initial package of reforms proposed by the new Colombian government — in fact, the Bill was presented to the Colombian Congress during the first week of the new administration's term.

By the end of 2022, the Colombian Tax Reform was approved by the Colombian Congress (Law 2277 of 2022). And while the law's passage sits in the rearview mirror, two new provisions intended to increase Colombian tax revenue pose upcoming challenges for inbound investors: (i) the Significant Economic Presence ("SEP") rule, and (ii) a modified corporate tax residency test.

SEP RULE

The SEP rule, which will go into effect January 1, 2024, creates a new taxable nexus criterion for non-resident companies. At base, non-resident companies are subject to SEP taxation if engaged in the sale of goods to Colombian clients and/or the provision of "qualified digital services" to Colombian clients/users.

Notably, Colombia has been part of the Inclusive Framework on BEPS since 2016 and, like other members of the Inclusive Framework, officially supported the OECD's "Two–Pillar Solution" for addressing the challenges of today's digitalized economy. Colombia's adoption of the SEP rule appears to run counter to the Inclusive Framework commitment to avoid introducing Digital Service Taxes or similar unilateral measures.

Nonetheless, by its own terms, the SEP rule should not apply where a Multilateral Instrument effecting Pillar 1 entry into force in Colombia (provided that the SEP rule is deemed to contravene that Multilateral Instrument).

Scope of the SEP Rule

The SEP rule should apply whenever the non-resident is directly engaged in the sale of goods or the provision of qualified services to Colombian customers/users, provided that two criteria are met:

(i) The non-resident has a "systematic interaction" with the Colombian market, *and*

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(ii) The non-resident derives income from such transactions, equal to or higher than USD290,000 (approximately) during the taxable year.

The rule generally provides that the activities of related parties must be aggregated for purposes of these tests, but the legislation contains no further clarification regarding the manner or extent of the aggregated approach. We expect this to be addressed in upcoming regulations.

The SEP rule provides two scenarios to illustrate when a non-resident has a ''systematic interaction'' with the Colombian market:

(i) There is interaction or marketing activities with 300,000 clients or users located in Colombia during the taxable year, *or*

(ii) The non-resident shows the prices in Colombian Peso (COP) or allows the payments to be made in Colombian Peso (COP).

Additionally, and subject to some significant exemptions (e.g., for digital education services), the SEP rule applies only to the provision of digital services — as well as the sale of goods, regardless of their nature — to Colombian clients/users.

Tax Liability Derived from the SEP Rule

The SEP rule was not created as an indirect tax applicable to the sale of goods or the provision of qualified services; rather, the intent was to include the SEP rule as a new nexus criterion for *income* tax purposes. Therefore, the SEP rule should not apply when the foreign entity is resident in a jurisdiction with a Tax Treaty in force with Colombia.

A non-resident that falls within the scope of application of the SEP rule may elect taxation under one of two mechanisms:

(i) A 10% withholding on the total amount paid (i.e., gross income); *or*

(ii) A 3% rate over the gross income declared on a Colombian tax return (in which case the 10% WHT would not apply).

The SEP legislation does not set forth specific conditions or mechanics for electing the 10% withholding versus the 3% gross income tax; this guidance is expected to be included in upcoming regulations.

CORPORATE TAX RESIDENCY TEST FOR FOREIGN ENTITIES

Similarly, the 2022 Colombian Tax Reform extended the concept of residency for Colombian domestic tax purposes. The expanded residency rules are applicable as of January 1, 2023.

Historically, foreign entities have been considered residents for tax purposes in Colombia when they have their effective place of management in Colombia. Effective place of management has been evaluated considering the location where the key management decisions of the company are made, taking all facts and circumstances into account.

The 2022 Colombian Tax Reform significantly expanded the scope of the management and control rule. Beginning in 2024, the determination includes the location of management decisions related to day-to-day commercial activities. Notably, once a company is considered a Colombian tax resident, it is subject to Colombian income taxation on its worldwide income.

Therefore, under the new Colombian domestic tax residency rules, a non-resident company should determine whether it has individuals located in Colombia who perform routine decision-making – even if that decision-making is limited to Colombian commercial activities. Should that be the case, and subject to further guidance in future regulations, the non-resident company risks treatment as a Colombian tax resident (unless the entity qualifies for tax treaty benefits that would change this conclusion).

U.S. FOREIGN TAX CREDIT CONSIDERATIONS

For U.S.-based multinationals, these two new rules spell the possibility of increased Colombian income tax, as well as the risk that the taxes may not be creditable in the United States.

The new SEP imposes income tax on a non-resident based solely on the location of customers. This type of ''destination-based'' tax (i.e., imposed based on the location of customers, users, or similar criteria) lands squarely in the crosshairs of the U.S. foreign tax credit (FTC) rules, which generally require the non-U.S. income tax base to be determined under principles that conform to U.S. income tax principles. Because U.S. income tax principles take a very different approach towards sourcing income – e.g., requiring that services be performed, or intellectual property be exploited, in the United States in order to be subject to U.S. income tax – the Colombian SEP tax appears to be non-creditable.

Whether FTCs are available for incremental Colombian income tax paid by companies under the expanded residency test is a little less straightforward. Regardless of whether the current Colombian corporate income tax (some elements of which are arguably inconsistent with U.S. tax principles) is eligible for U.S. FTCs, the new residence rule is not helpful for the analysis going forward. As noted above, creditability is predicated on conformity with U.S. tax principles. Consequently, Colombian taxation of residents

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must be consistent with U.S. resident taxation, and Colombian taxation of non-residents must be consistent with U.S. non-resident taxation.

The FTC regulations expressly accept non-U.S. residence rules that, among other measures, apply on the basis of management and control. However, it would not be surprising to see the U.S. challenge a variation of the ‘‘management and control’’ standard that is out of step with international norms. Moreover, it could be particularly challenging to benchmark the Colombian tax against the U.S. non-resident rules, because the United States does not impose worldwide taxation on non-residents.

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All in all, these two new provisions arising from the Colombian Tax Reform are notable not only for casting a wider net by expanding the Colombian tax base, but also because they contribute significant future uncertainty to what already is a challenging dynamic environment for determining the creditability of foreign taxes in the United States.

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