DESIGN AND IMPACT OF THE COLOMBIAN "SIGNIFICANT ECONOMIC PRESENCE" REGIME

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INTRODUCTION

Before and after joining the O.E.C.D. in 2020, Colombia was an enthusiastic adopter of international tax policies promoted by the O.E.C.D.'s B.E.P.S. Project. Two motivations spurred this action. First, the government wished to overcome technical gaps in the domestic legislation of cross-border taxation. Second, the government sought additional revenue from nonresident companies doing business with clients based in Colombia. This process began with the adoption of the inclusion of the permanent establishment and place of effective management regimes, the controlled foreign entities regime, and the imposition of V.A.T. on services provided from abroad.

However, the Significant Economic Presence ("S.E.P.) regime breaks with the tradition of adopting modifications in a way that is consistent with O.E.C.D. policies. It deviates from fiscal policy recommended by the O.E.C.D. by expanding the scope of domestic source income in order to tax suppliers of goods and services from abroad even when the suppliers maintain no permanent establishment in the country. Thus, Colombia has reacted unilaterally to impose tax on foreign suppliers of goods and services.

Colombia created the S.E.P. regime as a unilateral alternative to the global proposal of Pillar 1, rejecting this proposal based on two strategic considerations. The first was the low probability of global implementation. The second was the expansion of the tax base beyond that provided by Pillar 2.

Both reflect the policies of the Minister of Finance, Dr. José Antonio Ocampo, who developed a significant international reputation for fiscal activism for developing countries. Under his auspices, Colombia took a significant leadership role in the *Regional Platform for Tax Cooperation for Latin America and the Caribbean* that has as one of its main objectives the redistribution of tax powers of member states. His economic policies are reflected in the adoption of the S.E.P. regime.

THE S.E.P. AND INCOME TAX SYSTEM

At the international level, the proliferation of digital services tax ("D.S.T.") regimes in developing countries reflects the rejection of a bilateral approach to income taxation in favor of unilateral approach to expand the tax base. In the case of Colombia, the S.E.P. regime is clearly located in the area of income taxation. It simply expands the concept of national source, while adopting specific taxable elements of tax base and rates.

The purpose of the S.E.P. regime is to tax services that were not previously taxed by applicable legislation. Thus, for example, management and administration services

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provided from outside Colombia that already is subject to withholding tax of 33% is not covered by the S.E.P. regime. In the end, S.E.P. is a special form of national income tax that focuses solely on revenue generated from Colombian sources. It does not expand the concept of a permanent establishment. Had it done so, the S.E.P. theoretically could have allowed Colombia to tax the worldwide income like the country did with permanent establishments of foreign companies in 2019.

PROTECTION OF DOUBLE TAXATION TREATIES

In harmony with the recognition of S.E.P. as an income tax regime, the legislation includes an explicit reference to income tax treaties, confirming their priority in cases of S.E.P. This means that in those cases where a provider of taxable services under the S.E.P. regime is a resident of a country having an income tax treaty in effect with Colombia, the S.E.P. regime will not be applied by Colombia. This is due to the typical prevalence of Article 7 (Business Profits) focused on corporate profits, whereby only the country of residence would have the power to tax income not expressly covered under other articles of the income tax treaty.

This clear prevalence of the income tax treaty over the S.E.P. is not only valuable for the effect of digital services, but even more so for goods. As a result, business groups that are likely to come within the S.E.P. tax regime may restructure their internal supply chain so that sales to customers in Colombia will be made by subsidiaries located in an income tax treaty jurisdiction.

COVERAGE OF DIGITAL SERVICES OR SERVICES SOLD IN THE DIGITAL MARKETPLACE

The legislative process of the tax reform bill that included the S.E.P. regime left open the debate on whether the S.E.P. regime covered only digital services and services sold through a digital market or was intended to cover any services performed abroad for the benefit of a Colombian resident. The latter expansive reading would suggest that the S.E.P. is akin to a V.A.T. applied to services performed abroad by nonresidents.

This uncertainty was not resolved by the draft Regulatory Decree that was circulated in November 2023 or its final version. It was the Colombian Tax Administration, commonly referred as the "D.I.A.N.," that concluded the S.E.P. regime taxes only digital services or those services sold through a digital market. The conclusion of the D.I.A.N. is well supported by the analysis of the legislative evolution of this particular reform. So long as it does not change, any service that is not digital and not sold through a digital market is excluded from the S.E.P.

COVERAGE TO GOODS IN GENERAL

When Colombia adopted a D.S.T., it covered the generic category of "goods" without any conceptual restrictions or clarifying guidelines. As a result, goods include both tangible and intangible assets. The D.I.A.N. has simply confirmed its understanding that there is a generic coverage of goods in the S.E.P. regime. Consequently, Colombia adopted an expansive deviation from the international standard of not imposing income tax on the import of goods.

The sensitivity to a possible payment of income tax to the exporter of goods from another jurisdiction cannot be underestimated. Income tax is imposed at the rate of 3% on gross sales to Colombian customers if the supplier files a tax return or at a 10% withholding rate, which is both a final tax. With different source of income rules applied in Colombia and abroad, double taxation would exist, distorting Colombia's competitive position from the perspective of a supply chain.

The alternative to mitigate such inefficiency would be a gross-up of the sales price so that the seller achieves the same amount of after-tax profit.[1] It follows that this would generate an inefficient increase in cost structure for the Colombian importer. Ironically, this if this ultimately shifts the economic cost of the tax to the Colombian importer, contrary to the intent of the government.

In the case of suppliers from the U.S., where there is no S.E.P. antidote in the form of an applicable income tax treaty with Colombia, a Free Trade Agreement exists that restricts tariffs and nontariff measures that affect trade. Already, statements have been made by American trade associations about the potential violation of the Agreement resulting from the enactment of the S.E.P. regime. To the extent that the door to goods is kept completely open and the criteria on "deliberate and systematic interaction" – the threshold that must be reached in order for the S.E.P. regime to apply – remain very vague, the impact of the S.E.P. implies a risk of litigation with countries that fit the situation of the U.S.

In the circumstances, we believe that the Colombian Treasury and the D.I.A.N. have room to limit the coverage of S.E.P. on a discretionary basis so that it applies only to goods sold through a digital market, consistent with the interpretation regarding services. It would help the Colombian economy if this fine tuning is considered sooner rather than later in order to avoid inconvenient distortions in the structuring of businesses, international supply chains and Colombia's competitive position.

THE DEFINITION OF "SIGNIFICANT ECONOMIC PRESENCE"

The S.E.P. regime sought to extend the borderline of income taxation for those companies that sell digital services and/or goods to Colombian clients from a base that is located abroad without triggering a permanent establishment in Colombia. The configuration of the S.E.P. implies something innovative. It is therefore worth asking whether the legislation enacting the S.E.P. regime is clear and predictable.

Under the final legislation, taxpayers targeted by the S.E.P. regime are nonresident persons and nondomiciled entities. The latter covers companies, trusts, and private foundations established abroad. The legislation generically mentions the commercialization of goods or services without any qualification or restriction on the type of goods or services that are covered. Consequently, the term "services" was not restricted to "digital services." The legislation goes on to establish the rates of tax under the S.E.P. regime. Rates are provided for goods and digital services. No rate is provided for physical services. According to the D.I.A.N., this confirms that physical services are outside the scope of the S.E.P. regime.

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[1] A gross-up of prices is discussed in greater detail in the last portion of this article.

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Two combined features trigger the S.E.P. taxable event. The first is the notion of "deliberate and systematic interaction" with clients or users in Colombia. The second is gross revenues in relation to clients or users based in Colombia in the current year or in the previous year of 31,300 tax value units. In 2024, that represents approximately US$ 355,000. If either trigger is not met, the S.E.P. regime would not apply to the foreign supplier. Regarding the gross income metric, it is worth asking whether, as of January 1, 2024, certain foreign companies were already taxpayers via the S.E.P. regime, having exceeded the respective threshold during the 2023 fiscal period.

The trigger based on deliberate and systematic interaction contains no conceptual description of the type of interaction that would trigger a significant economic presence. Conceptually, it should be something less than a permanent establishment. But it should be enough to differentiate it from those services that are materially executed from abroad or from goods produced in another country that would not normally generate income from Colombian sources. In any event, every foreign provider of services or goods interacts with clients or users. No standard is provided to differentiate "deliberate and systematic" interactions from interactions that are less than deliberate and systematic.

There are, however, two explicit presumptions that may be used to determine whether a foreign supplier has interactions that are deliberate and systematic. The first presumption is the following:

> The non-resident person or entity not domiciled in the country maintains an interaction or marketing deployment with three hundred thousand (300,000) or more clients and/or users located in the Colombian territory during the previous taxable year or the current taxable year * * * .

This may mean that the interaction is a marketing display, without specifying that it must be through digital media, typically a website or social network. In this context, advertisements in newspapers or magazines, billboards, or advertisements in movie theaters might be viewed to be marketing displays. Accepting that the principal target is digital marketing, it appears that marketing on social networks such as X, Instagram, or Facebook converts the performance of extraterritorial services or the extraterritorial sale goods physically located abroad into territorial services and sales in Colombia.

This validity of the presumption is open to question because the method by which the threshold is achieved is not clear. It requires that the marketing display with target clients or users be maintained throughout at least one of the years in the two-year measuring period. Arguably, reaching 300,000 contacts on certain days of the year but not on all days or many days may not be sufficient. The above leads to compliance and oversight challenges because no guidance is provided as to how an exact measurement of the clients or users contacted by the marketing deployment will be executed.

The second presumption is very specific and easily verifiable.

> The non-resident person or entity not domiciled in the country maintains or establishes the possibility of viewing prices in Colombian Pesos (COP) or allowing payment in Colombian Pesos (COP).

"In sum, when advising a foreign supplier to confirm or rule out the application of the S.E.P., uncertainty as to the scope of the law should be emphasized."

Typically, website or social media posts aimed at Colombian residents will include prices denominated in Colombian Pesos, or will provide access to a Colombian Pesos conversion tool, or will allow payment in Colombian Pesos. This would cause a foreign supply to meet the presumption.

In this context, substantive legal questions remain that are not easily answered:

- If neither of the two presumptions are met, is the foreign company removed from coverage by the S.E.P. regime?
- How can the risk of coverage by the S.E.P. regime be ruled out when there is no conceptual definition of activity constituting deliberate and systematic interaction?
- Can the D.I.A.N. apply the S.E.P. regime to a Colombian client company that did not apply the 10% withholding tax by arguing that deliberate and systematic interaction occurred even if one of the two presumptions was not met?

In sum, when advising a foreign supplier to confirm or rule out the application of the S.E.P., uncertainty as to the scope of the law should be emphasized. For a Colombian company making payment to a foreign supplier, the situation is much simpler when the foreign supplier confirms having activated the S.E.P. regime and registers as an income tax payer in the tax registration system.

THE RATE DESIGN OF THE S.E.P. REGIME

The income tax system in Colombia for nonresidents, aligned with the dominant practice of Colombian income tax treaties, provides for the collection of withholding tax on gross income derived from Colombian sources. But in the case of permanent establishments of foreign companies, the system allows for the taxation of net profits by tax return through a special method of calculating the attributable profits.

The S.E.P. regime covers income not covered by this system, which means that there will be an additional dimension of income from national sources. Recall that the law allows nonresident to pay a 10% withholding rate on gross income or an income tax declaration of 3% on gross income. However, under the S.E.P. regime, the alternative calculation of profits is not allowed as the tax base is gross income. This restriction explains the selection of the relatively low rate of 3%, but this impossibility of deducting costs or expenses raises a constitutional concern, given that there are no precedents for an income tax return with this limited structure.

The Treasury encourages nonresident companies to establish subsidiaries or branches in Colombia in order to access a profits taxable base, an argument that would also be applicable to the application of fixed percentages of withholding on gross income. However, there would be a counterargument that the simplicity of the definitive withholdings is a legitimate option that at least is applied equitably. In contrast, the S.E.P. regime represents special treatment between those nonresidents that declare income tax subject to a 35% tax on profits, while nonresidents under the S.E.P. would pay 3% on strict gross income. To the extent that the cost and expense structure is heavier, and the profit margin is narrowed, the 3% might actually generate a higher effective tax rate than the other nonresidents that use the 35% nominal rate, without a clear tax policy justification.

Even accepting for the sake of argument that nonresidents could have different tax rules in relation to residents, the possible asymmetry generated by the option of declaring tax under the S.E.P. regime could fuel an intense debate before the Constitutional Court.

For now, it is likely that the majority of foreign companies will opt for the Income Tax return instead of the withholdings, unless the alternative of the 10% withholding can be better mitigated through the "gross up" mechanism that we explore below.

THE "GROSS UP" ALSO EXISTS

Use of a gross-up clause in contract negotiations is not an uncommon practice when a foreign supplier bills a domestic client. Certainly, this is prevalent in cross-border lending transactions and different types of services. Under a typical gross-up provision the price charged by the supplier is increased, so that after withholding tax is collected, the supplier is able to receive its target price, net of all taxes. In the context of the S.E.P. regime, where 10% withholding is applied, it cannot be ignored that the contractual position of the foreign supplier will be to demand a gross-up of the transaction price to arrive at a targeted after-tax amount. The formula used is straightforward, as follows:

The target price sought by the supplier ÷ (1 – the total tax rate)

In this manner, the Colombian tax cost is transferred to the Colombian customer. If the gross-up formula is part of the sales order, the traditional interpretation of the D.I.A.N. is that the amount of the gross up does not constitute a deductible expense for the customer. Ultimately, the tax is an expense of nonresident. The position of the D.I.A.N. likely is not enforceable where the gross-up computation is embedded in a simple price that is charged to Colombian resident customers without the application of the explicit gross up clause.

FINAL THOUGHTS

The S.E.P. regime likely was thought to be an easy way to tax digital companies based in other countries notwithstanding the difficulty of adopting Pillar One. However, it is not clear that the revenue target will be met. Even if met, use of embedded grossed-up prices may result in an effective tax increase for consumers in Colombia. This paradox should lead to the tax policy argument that any expansion of domestic source income should have the option of applying the income tax on a profits taxable base, which might mitigate the gross-up distortion.

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