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Withholding Taxes and Permanent Establishment Regulation in Colombia, in the Context of Attribution of Profits

In this issue, *Colombian_Tax_Flash*® comments on the general impact of Colombian withholding taxes on Permanent Establishments, in connection to a general ruling¹ issued by the Colombian Tax Authorities taking the position that withholding taxes apply on internal dealings related with the attribution of profits to Permanent Establishments under domestic regulation.

1. Permanent Establishment (“PE”) Regulation

In 2012 Colombia adopted a domestic PE regime that is inspired on the OECD regulation on the matter (particularly on the 2010 Profit Attribution Report).

According to this regime, PEs are taxed in Colombia on the Colombian source income that is attributable to them, considering their assets, activities, functions and risks. In order to determine the profits that are attributable to a PE, an attribution study is required. As part of the attribution process internal dealings should be recognized.

2. Withholding Tax Regulation

When Colombian source income is remitted abroad to a beneficiary that is a non-resident individual or entity, the payment is subject to a withholding tax.

On the other hand, most local payments are subject to a back-up withholding that can be deducted from the corporate income tax to be paid at the end of the year.

The rates at which local back-up withholdings should be performed differ from those applicable to withholding taxes on cross-border payments.

¹ General rulings are briefings that are not mandatory for Colombian taxpayers, but are mandatory for the Tax Service.

These rules are framed in the context of real transactions and not in the context of profits attribution.

With regards to transactions in which foreign companies that have PEs in Colombia participate, article 6 of Decree 3026/2013 establishes the following rules:

- Whenever a third party makes a payment to the company, which is attributable to the PE, such third party should perform the applicable local back-up withholding.
- Whenever a third party makes a payment to the company, which is not attributable to the PE, the third party should perform the withholding tax that applies on cross-border payments.
- Whenever a PE makes a payment to its home office, a withholding tax on cross-border payments applies and should be performed by the PE.

This set of rules is confusing, for the following reasons: (i) for a third party it is extremely difficult to know whether a payment is attributable to the PE or to its home office; (ii) under the domestic regulation on profits attribution, what should be attributed to the PE are profits and not individual payments made by third parties; (iii) it is not clear when would a PE make a payment or have an account payable with its home office, as technically they are parts of the same legal entity.

3. Withholding Tax on Internal Dealings Related with the Attribution of Profits to Colombian Permanent Establishments

On a recent general ruling (001421/2015), the Colombian Tax Authorities (DIAN) stated that a withholding tax applies on internal dealings related with the attribution of profits to a Colombian PE. The latter based on the argument that, for tax purposes, the PE and its home office are deemed separate entities. Additionally, the Tax Service cites part of article 6 of Decree 3026/2013, which states that a withholding tax applies on cross-border payments made by the PE to its home office.

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We do not, in principle, share the Tax Service position, for the following reasons:

- Internal dealings between a PE and the remainder of the enterprise are only notional transactions (with no real legal or economic effects), which are only recognized for transfer pricing purposes.
- In a cross-border scenario, withholding taxes only apply when a foreign entity is receiving Colombian source income. It is important to highlight that sourcing rules are different from attribution rules. Hence, the fact that the Tax Authorities mix these two concepts in the general ruling creates uncertainty.
- It is important to highlight that the recognition of internal dealings does not give rise to payments to be made by the PE, or to any other items of income that could be subject to a withholding tax in Colombia.
- In our view, article 6 of Decree 3026/2013 does not apply to internal dealings, for it specifically requires a Colombian item of income for the withholding tax to be triggered.
- The interpretation that the Tax Service subscribes to poses many difficulties for its implementation. In fact, since internal dealings are only notional transactions, it is not clear how the base on which the withholding tax should be applied would be valuated, at what time should the withholding be performed and who would economically support these withholding taxes, given that no payment would be completed. The latter also raises concerns with regards to the ability to pay principle.

It is important to highlight that on a previous general ruling (079443/2012), in which the Tax Authorities analyzed the effects of the attribution of expenses between a PE and its home office, in a treaty context, they concluded that no withholding tax should apply. Moreover, they affirmed that the attribution of expenses has merely fiscal effects (i.e. the PE does neither have an account payable nor is it obliged to make an outbound payment) and does therefore not give rise to a withholding tax.

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We agree with this interpretation and, although it was made in connection to the attribution to Colombian PEs of interest incurred abroad and not in the specific context of internal dealings, in our view, an interpretation on this line in connection to internal dealings would be much more reasonable. Moreover, it would eliminate the uncertainties created by the confusing applicable regulation and by the latest general ruling issued by the Tax Service.

Please bear in mind that this is a selective summary, for informational purposes only, that focuses on certain topics of interest. Therefore, it is not intended to be a detailed and comprehensive dissertation of the topics discussed. It is advisable that our readers do not exclusively rely on this document and thoroughly review their queries, seeking qualified advice from professional tax attorneys duly admitted to the practice of law in Colombia.

For more information on other changes in other pieces of legislation both at a national and local level, which are not featured in this issue of [Colombian Tax Flash®](#), you can visit us on twitter [@colombiatax](#).

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