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Recent Developments in International Taxation

Colombia

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Introduction

This report refers to some of the most critical judgments the Colombian Constitutional Court issued related to the rules settled by Law 2277 of 2022 (the most recent tax reform adopted in Colombia). In addition to the rulings discussed here and those not analysed due to the length limitation, several lawsuits are pending at the Court against other Law 2277 of the 2022 provisions. This report will only refer to the lawsuit against the minimum effective tax rate adopted by Law 2277 of 2022, allegedly following the guidelines of Pillar Two of the Organisation for Economic Co-operation and Development's (OECD's) base erosion and profit shifting (BEPS) project.

Furthermore, the report underscores the importance of the recent regulatory decree issued by the Colombian Government (the 'Government') regarding taxation for significant economic presence. The recent tax reform adopted this rule and was extensively commented on in the *2023 National Report*. It is strongly recommended that you read it to understand the topic comprehensively.

Lastly, a brief but significant reference is made to a recent ruling by the Council of State on the most favoured nation (MFN) clause, a provision enshrined in some of the double taxation agreements (*convenio de doble imposición*s or CDIs) signed by Colombia. This ruling holds substantial implications and should not be overlooked.

Reference to judgments of the Constitutional Court related to provisions included in the most recent tax reform, Law 2277 of 2022

Additional references to the lawsuit, not yet decided by the Court, against the minimum tax applicable to corporations are as follows:

Judgment C-483, 2023 – presenting judges: Jorge Enrique Ibáñez Najar and Cristina Pardo Schelisnger

Through this ruling, the Court declared paragraph 1 of Article 19 of Law 2277 unenforceable, which established the prohibition of deductibility of royalties due to the exploitation of non-renewable natural resources. This rule affected companies in the hydrocarbon and mining sectors as, in the process of income purification, it prevented such companies from subtracting the amount paid as a royalty or the cost of production of the royalty when it was delivered in kind to the state.

The Court declared the provision unconstitutional based on the following arguments: (1) the provision established differential treatment between those who pay the royalty in

kind and those who pay it in money, which was inadmissible from the point of view of the principle of tax equity; (2) the provision did not take into account the fact that the royalty had to be paid compulsorily by the exploiters of non-renewable natural resources and that it constituted a structural reduction; (3) that because the payment of the royalty was mandatory, it was essential for the development of the income-producing activity, and taking into account that its amount could even reach 25 per cent of the price of the product exploited at the wellhead, the provision overlooked the principle of the contributive capacity regarding the exploiters of non-renewable natural resources; (4) likewise the provision failed to observe the principle of legitimate trust given the fact that the investors signed the contracts and made the investments with the understanding that the payments made for royalties would not increase their income tax base; (5) the provision could have confiscatory effects during periods of low prices because the non-deductibility rule was established by the legislature permanently, without conditions, exceptions or compensation rules. Thus, it does not provide guarantees of non-confiscation for cases in which the artificial increase in the tax base, derived from the prohibition of deduction of royalties, increases the tax due when the economic activity reports losses.

The Government requested the clarification of the judgment and its annulment, both of which were denied by the Court. Finally, through the Ministry of Finance, the Government filed a 'fiscal impact incident' through which it requested some of the following measures to be adopted so as not to affect the fiscal sustainability of Colombian public finances: (1) defer the effects of the ruling until 1 January 2025; (2) defer the effects of the sentence until 1 January 2024; (3) modulate the effects of the ruling in the sense that concerning the taxable years 2023 and 2024, the royalties are non-deductible from income tax and that the highest value of the tax for this concept is recognised as a discount in equal instalments in the taxable years 2024, 2025, 2026, 2027 and 2028; or (4) modulate the effects of the ruling in such a way that for the taxable year 2023 the royalties are non-deductible from the income tax and the highest value of the tax for this concept is recognised as a discount in equal instalments in the taxable years 2024, 2025 and 2026.

It is important to note that the 'fiscal impact incident' filing was initially ruled as inadmissible by the Court. Afterward, the Government filed a memo to remedy the incident, and on 8 May 2024, the incident was admitted for study by the Constitutional Court. For the purpose of the incident, the plaintiff and the Ministry of Finance were

summoned to a hearing that took place on 14 May. After that hearing, the Court had to decide whether the incident proposed by the National Government was successful.

It should be noted that most companies in the mining and hydrocarbon sector submitted their income tax return before the order of admission of the incident of fiscal impact was notified. The order suspends the effects of the judgment from its notification until the incident is resolved. In that sense, the companies have already requested, as deductibles, royalties or the production cost related to royalties because, by the end of the fiscal year, the ruling had full effect. Thus, it is unlikely that the Court will agree to defer the effects of the ruling on what has to do with the year 2023, mainly because the principle of non-retroactivity of tax law and respect for consolidated legal situations are at stake. However, we have to wait to know what the Court finally decides regarding the effects of this ruling, which is crucial for foreign investment in Colombia. It is worth remembering that foreign investment in Colombia in the field of hydrocarbons and mining is quite considerable, and that the 2022 tax reform, through the non-deductibility of royalties and the income tax surcharge that was imposed on the sector, hit the profitability of these businesses hard in the country.

Finally, it is important to clarify that the mining and hydrocarbon sector surtax was sued before the Constitutional Court. As of the writing of this report, the Court has not decided whether the provision is unconstitutional.

Judgment C-435, 2023 – presenting judge: Alejandro Linares Cantillo

This ruling dealt with the constitutionality of Article 54 of Law 2277 of 2022 on the tax rate on ultra-processed sugary drinks, one of the healthy taxes adopted in recent tax reforms in Colombia. According to the plaintiff, the rate, having been established based on the sugar content of the drink and not on its value, violated the principle of equality, resulting in a detrimental effect on lower-income Colombian people, while at the same time failing to observe the principles of economic freedom and free competition.

Concerning the charge related to the alleged violation of the principle of equality, the Court specified that the tax on sugary drinks has an extra-fiscal purpose consisting of discouraging the consumption of ultra-processed sugary beverages and that the rate determined with an objective criterion, specifically the level of sugar per millilitre of the marketed beverage, and not based on subjective criteria, such as the contributory capacity of consumers, was in accordance with the Constitution again because its purpose is to discourage the consumption of a substance harmful to Colombians' health.

Thus, the Court concluded that people with greater or lesser ability to pay were equal in the face of the tax and should receive the same treatment given the purpose of the rule.

Now, regarding the charge of an alleged violation of economic freedom and free competition, the Court stated that the legislative power has a wide margin of regulatory configuration, so although the measure effectively generated an impact on the free market because the rising price of ultra-processed sugary drinks discourages their consumption, the limitation was reasonable and proportionate in light of the general interest because its objective is to protect and improve the health of Colombian citizens.

Judgment C-384, 2023 – presenting judge: Diana Fajardo Rivera

Through this case, the Court ruled the conditional constitutionality of numerals 1 and 2, and paragraph 6 of Article 240-1 of the Tax Statute, as modified by Article 11 of Law 2277, which regulates the preferential tariff regime for industrial users of free zones for income tax purposes. Before the modifications introduced by the 2022 tax reform, the rule specified that free zone users would enjoy a 20 per cent income tax rate on all their income. The reform restricted the applicability of this preferential rate only to income perceived by exports. Thus, the Court concluded that it was a radical and untimely modification of the preferential tariff regime, which is why it anticipated that the new limitation would not apply to the industrial users of free zones qualified as such before 13 December 2022, because they had modelled their activity and behaviour according to the requirements to access the qualification of industrial users in free zones and the corresponding tariff regime. All this safeguards the principles of good faith and legitimate trust enshrined in Article 83 of the Constitution. Accordingly, the Court maintained the requirements of the special tariff regime provided by the regulations before the tax reform for all those who had met the conditions to access it before 13 December 2022, the date of entry into force of Law 2277 of 2022.

Lawsuit against the minimum tax rate for corporations

Currently, the Constitutional Court is studying a lawsuit against the minimum refined tax rate (*tasa de tributación depurada* or TTD), provided for in paragraph 6 of Article 240 of the Tax Statute, as added by Article 10 of Law 2277 of 2022. The defendant rule established a minimum tax rate for all legal entity taxpayers of 15 per cent, calculated on the adjusted profit of the companies. Although the provision, in its legislative history, claims to be based on Pillar Two of the OECD, the truth is that it is far from what is considered to be a minimum tax provided by the guidelines of Pillar Two, for the reasons

explained in the 2023 annual report, which you are invited to read for a greater understanding of the matter, which are reiterated below:

> '[…] First, it applies to any type of taxpayer, not only to multinational companies or companies that consolidate financial statements.
>
> Second, the tax purpose is that no legal entity is taxed in Colombia with an adjusted tax rate (Corporate Income tax) of less than 15%, regardless *of their income or category.*
>
> Third, in the case of parent companies of multinational groups that consolidate in Colombia, it applies to any amount of consolidated annual income, so it does not observe the minimum of SEVEN HUNDRED FIFTY [750] million euros recommended by the OECD as a threshold.'

The claim, on which the Constitutional Court has not yet ruled, is based on the fact that this minimum tax does not refer to the taxable capacity because it is calculated based on accounting profit and not tax profit. Therefore, it does not consider the fact that the accounting figures may contain, and do so recurrently, expressions of income and potential financial or accounting profit that do not correspond to the enrichment, even likely, of the company or person to which they belong. Furthermore, the plaintiffs argue in their brief that it can lead to unfair situations of double taxation. In addition, the provision lacks sustenance because it does not comply with the minimum tax proposed by the OECD, even though it claims to be justified in Pillar Two of the BEPS project, all of which makes it very possible for the Court to declare its unconstitutionality. It should be noted that the request for an unconstitutionality declaration of the provision has received the support of practically all those involved in the process, including prestigious universities in the country, recognised tax experts, the Colombian Tax Law Institute and even the Attorney-General's Office.

Decree 2039 of 2023: taxation of non-residents for significant economic presence in Colombia

As noted at the beginning of this report, the Government recently issued a decree that regulates the taxation standard for non-residents due to their significant economic presence in Colombia, which is aimed at taxing digital services provided from abroad by non-residents and was the subject of analysis for the *2023 National Report*. Decree 2039 of 27 November 2023 establishes the applicable rules for the payment or effective collection of the tax corresponding to entities with significant economic presence in the country, either as tax filers or through withholding at source. Additionally, within the details contained in the decree, the following are highlighted: (1) definitions of the

expressions provided in the regulated standard to provide greater clarity to its application, such as clients, users, digital interface and digital services; (2) criteria to determine when it is understood that clients and/or users are located in Colombian territory to determine whether or not the standard is applicable; (3) the precedence for withholding agents if several of them come together in the same operation, to establish the withholding obligation clearly and make possible the effective collection of the tax that may apply; (4) the determination of supporting documents for the operations carried out with non-residents that have a significant economic presence in Colombia for the purposes of the deductibility of the expense for users and the deductible taxes in the VAT, if any; and (5) the formal obligations that withholding agents and entities or persons with a significant economic presence in the country must observe so that they have absolute clarity about their tax duties and the consequences of non-compliance.

Judgment 25411 of 4 April 2024 – Council of State: inapplicability of the MFN clause when what exists is not the reduction of a tax rate applicable to an income of a specific nature but rather the change of nature or legal classification of the income

To conclude this report, it is appropriate to refer to Judgment 25411, by which the Council of State denied the application of the MFN clause for the double tax treaties (DTT) signed between Colombia and Spain, Chile and Switzerland due to the enforceability of the DTT signed between Colombia and the United Kingdom. On the one hand, regarding the DTTs signed with Spain, Chile, and Switzerland, technical assistance and consulting services were classified as royalties subject to ten per cent taxation in Colombia according to Article 12 of those DTTs, regardless of where they were rendered. On the other hand, in the DTT signed with the UK, such services were not considered among those generating royalties according to Article 12, but those that produce business profits. According to the DTT, business profits are taxed in the provider's country of residence. They are only subject to taxation in the user's country if the income is earned through a permanent establishment in that state. Therefore, the DTT with the UK did not reduce the tax rate applicable to an income of a specific nature but rather changed the nature or legal classification of the income, a situation that does not trigger the MFN clause in the DTT signed with Spain, Chile and Switzerland.