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# International Law Practicum

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## Practicing the Law of the World from New York



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# Debt Collection in Latin America

By David Franklin and Romelio Hernandez

## I. Introduction

International commerce and global trade brings with it not only the anticipated profit and paralleled business opportunities, but also the prospect of uncollected trade debt: it exposes the supplier of goods and services to financial risk. A creditor is then faced with a search for unencumbered assets of a debtor, most likely outside the creditor's own jurisdiction.

In an international contest, the creditor is faced with certain challenges that it would not find in a wholly domestic dispute. This article serves to outline certain of the obstacles to international debt collection.

International commercial debt recovery is similar to three-dimensional chess, with the law of the creditor, the law of the debtor, and international treaties taking important roles.

Take, for example, a default judgment rendered in New York against a Mexican company. Can such a judgment be domesticated and recognized in Mexico? Questions that might arise are the following:

- Is there sufficient connection of the Mexican company with New York?
- Was there proper service according to the Hague Convention of Service of Legal Proceedings?
- Was there sufficient and proper notification?
- Is the judgment fair and not against Mexican law?

## II. Various Considerations

The following might be useful in considering the handling of an international debt collection.

### A. Contingent Fees

In Canada and the United States, it is common practice to forward and accept claims between forwarders and attorneys and creditors on a purely contingent basis; that is "no recovery, no fee."

However, there are many countries where the laws or rules regulating the conduct of attorneys prohibit acceptance of such mandates. In such a situation, lawyers must act on an hourly basis. Lawyers who accept claims on an hourly rate will, invariably, require an advance retainer against such fees.

### B. Choice of Foreign Attorney

Selecting a lawyer in a foreign country must be carefully considered. Competency, reliability and honesty are critical. Also, to find a law firm that is willing to accept claims on a purely contingent fee basis, and that is enthusiastic in doing so, is another challenge.

That is another reason for joining the Creditors Rights Committee of the New York State Bar Association: This Committee is partly dedicated to international commercial debt recovery, and its members can be a resource for finding and vetting foreign lawyers experienced in debt collection.[1]

### C. Power of Attorney

In Mexico and most of the Latin American countries, authorizing a foreign attorney might require a formal power of attorney, which must be executed before a notary public, accompanied by a certificate of the Secretary of State of the jurisdiction where the notary practices, and then sometimes authenticated by the consulate or embassy of the foreign country where the foreign attorney is located. This, however, might create problems of having to prove foreign law regarding the power of attorney, or having to conform with local rules where use of the power of attorney or enforcement is sought, based on different governing law principles.

One alternative to avoid the problem is to look into International Conventions that might provide guidance as to the proper legal form that will be recognized in Latin American countries. The first is the Inter-American Convention on the Legal Regime of Powers of Attorney to be Used Abroad, which was adopted by OAS members on 30 January 1975, in Panama City. To this day, most Latin American countries have adopted this Treaty, but Canada and the USA are not signatories. The second is the Protocol on Uniformity of Powers of Attorney to be Used Abroad of the Pan-American Union (now OAS), also known as the Washington Protocol of 1940. This Treaty has a longer history and thus interpretation by courts might be more consistent and reliable, such as the case of Mexico, where the Supreme Court has ruled and confirmed the scope and applicability of powers of attorney executed abroad under the Washington Protocol in relation to powers of attorney executed in Mexico under domestic laws. The difference here is that the USA is part of the Treaty, and therefore powers of attorney to be signed in the USA can be executed under the Washington Protocol. The question is then left for Canadian parties (since Canada is not a signatory to this Treaty): would it be wise and possible for Canadian parties to grant powers of attorney in the USA under the Washington Protocol instead of executing them in Canada?

As stated above, after a power of attorney is executed, authentication will be required. The method of authentication is determined by the country in which the document is intended for use.

The first method of certification is by obtaining an Apostille certificate, which is provided for under the Hague Convention Abolishing the Legalization of Foreign Public Documents ("HLC"). The Department of State office where the Notary Public is commissioned is responsible for providing said certificate. The purpose of the Apostille is to certify the authenticity of the signature and capacity of the public official (Notary) who signed the document, as well as the authenticity of any stamp or seal affixed to the document. This simpler form of authentication only applies to the approximately sixty member countries and states which are currently signatories to the HLC. The United States is a signatory to the HLC, but Canada is not.

Furthermore, a Letter of Authorization by the creditor addressed to the foreign attorney might suffice to demonstrate to the debtor that, indeed, the foreign attorney has authorization to negotiate on behalf of the creditor. This Letter of Authorization might be enough to attempt pre-legal collection efforts, but not necessarily sufficient to begin formal legal proceedings.

Without this power of attorney or Letter of Authorization, as the case may be, the claim often cannot progress.

### D. Arbitration Clause

Quite often, the creditor has, in its terms and conditions, an arbitration clause providing for arbitration in the jurisdiction of the creditor. There, again, such a clause must be adhered to and legal proceedings instituted in the jurisdiction of the debtor may be dismissed. Such clauses are valuable in complex commercial matters and especially if the creditor feels uncomfortable suing in the jurisdiction of the customer/debtor-to-be.

It is questionable whether an arbitration clause is effective in modest claims of, say, $100,000.00 or less. Arbitration entails the expenses of the arbitrator (there might even be three involved on the panel). In addition, the arbitration award would then have to be homologated in the country of the debtor in order to be considered as a judgment. This means that creditors will end up retaining and paying two attorneys: one abroad where arbitration is conducted, and another one locally, where enforcement is sought.

Based on the writer's experience, very often the creditors for modest claims regret that there is an arbitration clause. However, if there is one, it cannot be ignored and, taking legal proceedings before the ordinary courts would, invariably, be met with an application to dismiss.

Another question is raised with clauses that provide for arbitration as an option to the moving parties. In the case of Mexico, clauses that give exclusive option to one of the parties to select jurisdiction and venue are deemed null and void. It is therefore wise to confirm the validity of such clauses in each jurisdiction where enforcement will be sought, and to consider an exit strategy where such a clause might pose problems. More on this will be discussed below in Part II.F.

### E. Applicable Law

Although the creditor may have agreed in a contract or a credit application as to which law applies in the event of a dispute, usually the contractual basis is merely an exchange of a purchase order, confirmation and invoice, where there is total silence to the applicable law. The question, therefore, becomes: Where was the contract made and, therefore, which law applies? One cannot assume that the legal system of the debtor will be similar to that of the creditor. And where governing law has been agreed to, how are these governing law clauses interpreted or enforced in the local courts? Is foreign law easily proved in Latin American countries? What are the consequences of affording jurisdiction to the courts in Latin America, but subjecting the transaction to some foreign law? Is this always the best strategy?

### F. Choice of Jurisdiction Clause

Quite often in the contract, the creditor and debtor have agreed that all disputes will be heard before a court of competent jurisdiction, for example, New York. This clause cannot be ignored by taking proceedings initially in Mexico, where the debtor is located. The lawyer for the defendant will raise this as a preliminary objection and have the case dismissed.

One issue of importance is the validity of jurisdiction clauses. Are any and all jurisdiction clauses recognized as valid and enforceable in Latin American countries? Are there any constraints, requirements, or minimum formalities that must be met in order for such clauses to be considered valid and enforceable? The case of Mexico provides just one example: Jurisdiction clauses will only be deemed valid as long as both parties "clearly" and "conclusively" waive any jurisdiction afforded to them by the local governing law, provided that they choose a venue where any of its domiciles is located, or where any of the obligations from the parties are to be performed. Are there any such requirements under other Latin American countries that we should be aware of?

Another problem might also come in terms of optional jurisdiction and venue clauses. As stated above, clauses that give exclusive option to one party to select jurisdiction and venue are deemed null and void in Mexico. What happens when we already have a defective clause (such as this or the one discussed in the previous

paragraph) and we have to decide where to sue? What local remedies would allow creditors the best strategy for reliability? Using preliminary proceedings for formal recognition of debt as a way to confirm jurisdiction might provide an answer in some cases, without adding the risks of dismissal as to the merits of the case will not be ruled on by the Mexican courts. What happens in other Latin American countries? Are there any other strategies that could work as a possible solution?

### G. Statute of Limitations

Be aware that claims can be time barred and that the time period might be different from that of the jurisdiction of the creditor. An interesting question is whether the prescriptive period follows the law of the contract or that of the jurisdiction where the dispute is being heard. Is prescription (limitation) a substantive or a procedural issue to be considered?

### H. Foreign Language

Documents which are in English will invariably have to be translated by an official court translator into Spanish in Latin American countries, the official language of most such countries except Brazil, where Portuguese is the official language. It is generally not sufficient for the creditor to provide a translation, since the translation must be an authentic translation approved by the foreign court, even though this is at an additional cost. Trials will be held in the official language where the case is brought.

### I. Claiming Attorney and Collection Charges, etc.

Just because it is written in the contract, not every jurisdiction will award attorneys' fees, interest, administration charges, etc. This is all the more the case for penalty clauses, which may be regarded as against the public order of the foreign country, as they are in the United States.

### J. Personal Guarantees

A personal guarantee might be unenforceable in a foreign country if not properly drafted or executed. It is quite common that a personal guarantee will be incorporated as a paragraph within a corporate credit application. An example would be a clause that states that the person signing on behalf of the corporation is also personally liable. Some jurisdictions require that the guarantee be a separate document, clearly indicating that it is a personal guarantee.

## III. Forum Shopping: Where to Sue

If the creditor decides to institute legal proceedings against a debtor in the creditor's jurisdiction with the strategy of having the judgment domesticated in the jurisdiction of the debtor, it is paramount to always consult with a local attorney practicing in the jurisdiction where the debtor is located for the following reasons.

### A. Proper Service and Notification

Commencing legal proceedings against a debtor in your own jurisdiction by service and notification to the debtor in his jurisdiction by registered mail might not be enforceable when trying to enforce it in the court of the debtor. Objections may be raised that the debtor was not properly served in the originating jurisdiction if the original method of service does not comply with the debtor's jurisdictional requirements. It is advisable to conform to the Hague Convention on Service of Legal Proceedings.

### B. Description of the Parties

The local attorney should verify the correct corporate description of the debtor. It is often the case that the creditor is misinformed as to the actual correct description of the debtor. Creditors often confuse a trade name with the actual legal description of the debtor. A debtor that is described improperly in the action may be unenforceable when it is to be domesticated.

### C. Role of Correspondent Lawyer

The local attorney should review the allegations of the statement of claim or complaint so that if the foreign court is asked to domesticate the foreign judgment, it may view with approval that the originating court had jurisdiction due to the facts alleged in the proceedings to substantiate the real and substantive connection.

The local attorney should discuss with the correspondent lawyer for the creditor the enforcement and recognition (domestication) of the foreign judgment. Many times there are requirements or formalities under constitutional due process clauses that must be considered and satisfied upon service of process, such as the opportunity to be assisted and represented by a public defendant.

The local attorney should discuss the issues dealing with the execution of the judgment against the assets of the debtor. In many jurisdictions, certain assets are exempt from seizure, particularly if the asset to be attached and sold is for personal use.

### D. Debtor's Assets

The local attorney should investigate the debtor thoroughly and confirm that the debtor has any assets of sufficient value to satisfy payment of an award. There is nothing worse than trying to enforce a judgment against a bankrupt debtor. Therefore, jurisdiction should be considered in terms of the place where sufficient assets are found.

### E. Remedies Sought

Injunctive relief is seldom provided in Latin American countries, or it is provided under a different nature and with distinct features and limitations. Where an injunction proves to be the best remedy (backed up by the power of contempt), it is wise to reconsider fully the op-

tions of jurisdiction. Punitive damages are also of limited availability in Latin America. Another important type of claim to be considered is concealment of assets through fraud, specifically, abuse of the legal entity. Complex cases as these get different treatment in almost every Latin American country, and in some places remedies are either ineffective or inefficient, or both. Is this a scenario, would it make more sense to sue in the creditor's jurisdiction, provided that conditions for effective and efficient remedies are met?

## IV. Conclusion: Strategy

In light of the above, a creditor must make several decisions in international debt collection. But probably the most critical one is where to sue the debtor. In a pure debt collection, the logical choice is the jurisdiction of the debtor. But if the creditor can foresee that there might be a defense or even a counterclaim, the creditor must make a strategic choice of the forum most advantageous to the creditor. It is best to consult beforehand with a lawyer where the debtor is located to determine if a resulting judgment will be enforced.

The creditor may choose to institute proceedings in its own jurisdiction, with the hope that it can convince the local domestic court that it has jurisdiction, and that there is sufficient connection to allow the court to render judgment.

## Endnote

1. In addition, see *You have a Problem Where? – Selecting and Managing International Counsel*, 24 *Int'l L. Practicum* 3 (2011), for a panel discussion on the retention of legal counsel in foreign jurisdictions.

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# Debt Collection in Mexico

By Romelio Hernandez

## I. Introduction

This article discusses some of the legal issues relating to commercial debt collection in Mexico. Included are some legal strategies behind the interplay of international laws affecting both the creditor and debtor, and the impact of international treaties related to international contracting and litigation.

## II. Issues

### A. Fee Structure

While contingency fee mandates are common in the United States, local bar association rules in many Latin American countries may prohibit contingent fee arrangements. However, there is no legal obligation in Mexico for attorneys to belong or be admitted to a bar association in order to practice law: The successful conclusion of a law school program in Mexico is enough. Thus, Mexican lawyers are not necessarily bound to a Code of Ethics for the practice of law, including arrangement of fees. Typically, each one of the states that comprise Mexico will offer some regulation with regard to legal fees, but these will typically apply when there is a dispute as to what amount the attorney is entitled, and for purposes of obtaining a court award for attorney fees against a losing party. These laws, however, do not restrict fee arrangements between professionals and their clients, who are free to agree on any detail or amount, subject only to the general regulations and limitations imposed by the law of contract, such as the absence of duress, error, bad faith, arrangements contrary to public policy, etc.

Because of this lack of limitation, attorneys and clients are free to choose any kind of fee arrangement that best accommodates their firm structure or the clients' needs. There is no "usual" practice. In Mexico you can find all sorts of arrangements, from contingency to hourly and fixed fees. Contingency fees for collection cases are very common, and the rate will usually range anywhere from five percent to thirty-five percent, depending on many factors such as dollar amount of matter at hand, nature of claim and risks involved based on supporting documents, and the collectability estimate that is based on the debtor's legal and financial situation. Hourly fee arrangements, made more prevalent due to the influence of the large U.S. Law firms that have opened in Mexico, also vary substantially. Some firms will have a variation of their hourly schedules ranging from US$100 to US$400, depending on several factors, such as involvement of partners and associates, size and reputation of firms, etc.

The last type of arrangement that is common is based on a fixed fee that is paid in stages. Many attorneys (usually, although not exclusively, small firms or solo practitioners) use this type of arrangement to handle the case throughout the stages of litigation, usually in the form of a percentage of the total dollar amount of the claim. Under this arrangement it is common to see requests for an initial retainer or advance of fees prior to or at the time of filing of the complaint. It is also common for attorneys to request an advance for costs (for example, translations, certifications, etc.), which may be substantial and must be considered by counsel representing foreign clients.

### B. Powers of Attorney

Companies that intend to pursue legal actions in Mexico must usually appoint a legal representative through a formal power of attorney to act on its behalf before the courts. An exception to this rule would be in situations where foreign creditor companies have properly assigned such credit rights to an individual who is to act before the courts and exercise rights in its own right. Absent such an assignment, a formal power of attorney will be needed. Such powers of attorney must be carefully drafted, and must also conform to either one of the following international treaties:

- The Washington Protocol on the Uniformity of Powers of Attorney Which are to be Utilized Abroad of 1940.
- The Panama Inter-American Convention on the Legal Regime of Powers of Attorney to be Used Abroad of 1975.

Both of these treaties provide for the minimum of legal requirements that will have to be satisfied in order to have full effect in Mexico. Some of the requirements include the following:

- **Certification and attest by a Notary Public**. A Notary Public must attest that the company granting the power of attorney was duly formed and is legally existing and that the individual acting on behalf of the company has capacity and authority to delegate special and general powers of attorney, etc.
- **Purpose and extent of the power of attorney**. The purpose and limitations of the power of attorney must be established in precise terms, e.g., for lawsuits and collections, to buy and sell goods, to manage the company's business, etc.
- **Language**. The power of attorney may be granted in a foreign language, but it must be submitted with a Spanish translation.
- **Authentication of power of attorney**. The Notary Public's signature and certification must be authen-

ticated for it to be effective in Mexico: This can be by way of an *Apostille* or by consular legalization, depending on the location of the grantor of the power of attorney.

- **Filing**. Although not mandatory, it is recommended that powers of attorney be filed in the Public Registry for Commerce in such city or state office where the power of attorney is to be used. Although the Supreme Court of Mexico has already ruled that this is not a mandatory requirement, the filing nevertheless will avoid challenges by defendants as well as further delays in the courts while ruling on them.

These are just some of the requirements provided under the treaties. In Mexico, the issue of capacity and legal representation is examined *ex officio* and *sua sponte* by the courts. Therefore, securing and preparing a valid power of attorney from clients to represent foreign companies in Mexican courts, you should seek further legal advice from a Mexican attorney to make sure that all requirements are met and that the risks of a challenge are mitigated as much as possible.

### C. Arbitration

Any discussion of international debt collection should consider the effectiveness or even the desirability of an arbitration clause.

Mexico has been a party to the 1958 New York Convention on Recognition and Enforcement of Foreign Arbitral Awards since 1971. In 1993 Mexico amended its Commercial Code substantially to incorporate the 1985 UNCITRAL Model Law on International Commercial Arbitration ("Model Law"). In 2011, the Mexican congress passed legislation to amend the Commercial Code, to reflect some of the 2006 changes to the Model Law. These last changes sought to bring Mexico up to date with current international trends and eliminate the risks associated with the enforcement of arbitration clauses and arbitral awards. The 2011 changes touch on key areas such as: (i) the enforceability of the arbitration clause and, thus, settling the *Compétence-Compétence* principle; (ii) identification of specific judicial proceedings for enforcement of arbitral awards, as well as for resolution and handling of other important issues such as nullity actions, challenge of venue, appointment of arbitrators, court assistance for the taking of evidence, etc.; and (iii) state court recognition of interim measures issued by the arbitration tribunal.

The first issue regarding *Compétence-Compétence* has now been properly addressed under the Commercial Code to settle once and for all an issue that was recurring in litigation, which the Supreme Court had previously left to the judicial courts. Today, the Commercial Code overrides that principle and provides that the arbitration tribunal will be the one with jurisdiction to hear nullity actions or challenges against the arbitration clause or to the agreement thereof. This is a big step in achieving certainty and in support of arbitration.

The last two issues, regarding identification of judicial proceedings and recognition of interim measures, were grey areas within Mexican law, and allowed for delaying tactics and further litigation because of uncertainty. Proper proceedings have now been identified to address all these many challenges and remedies, which make for a more predictable process, both of arbitration and of enforcement of arbitral awards through the state courts.

Without a doubt, the 2011 amendments have made arbitration in Mexico—at least from a theoretical standpoint—a much more predictable and reliable form of dispute resolution. This is an option that should merit serious discussion in planning or evaluating prosecution of legal actions abroad through the courts or through arbitration, when the potential of enforcing such awards in Mexico is real.

### D. Jurisdiction and Choice of Law

Often in international commercial claims, one sees clauses, either in contracts or in credit applications, dealing with "applicable law" and "choice of jurisdiction." These are two distinct items with distinctly different legal meanings.

Historically, Mexican courts have resolved problems of choice of law and choice of jurisdiction in inconsistent ways. This is particularly so in the order of how these issues are addressed, which has significant consequences. The trend—and probably the best course of action—is to first resolve the question of jurisdiction and leave the issue of choice of law second.

Following Mexico's adoption of the 1979 Inter-American Convention on Proof of and Information on Foreign Law in 1983 ("Convention on Foreign Law") and the 1979 Inter-American Convention on General Rules of Private International Law in 1984 (the "Montevideo Convention"), key amendments were made to Mexico's Federal Civil Code in 1988 to introduce new conflict of law rules that explicitly authorize a Mexican court to apply foreign law. Prior to 1988, Mexico had followed a heavy territorial or local policy approach, where foreign law was rarely considered—as was evidenced by the lack of adoption in the Code of a method for interpreting and incorporating foreign law. Based on this policy, choice of law clauses were at times interpreted as jurisdiction clauses, and jurisdiction and venue were subject to choice of applicable law rules.

In other words, courts would usually assess choice of applicable law first, and only if those rules pointed to Mexican law would they assert and confirm jurisdiction for adjudication in the specific matter at hand, based on Mexican laws of procedure. Under that view, courts could

find it difficult to assert jurisdiction over a matter with a choice of law clause that pointed to foreign law.

Although the amendments of 1988 were intended to change the system to make Mexican courts receptive to foreign law, some old practices still persist. Thus some courts are still hesitant to follow the modern trend, and instead choose first to solve choice of applicable law, leaving the issue of jurisdiction to be decided based on their prior finding.[1] Moreover, many problems of insufficient court infrastructure, constrained budgets, and overwhelming workload in most jurisdictions make courts more friendly and open to challenges on jurisdiction based on these and other related grounds.

This historical introduction is important in showing us how some courts might react to these issues and in allowing us to come up with the best strategy beforehand, in connection with forum shopping. The lesson here is that jurisdiction and governing law clauses in international contracts that are to be enforced in Mexico are important, and clarity as well as consideration for Mexican law will always be key. With this in mind, we now turn to some drafting suggestions for enforceable clauses.

In regard to choice of law clauses, the 1994 Inter-American Convention on the Law Applicable to International Contracts (the "Mexico Convention") can provide some insight as to the way in which these clauses will be construed by the courts. The problem with this Convention thus far is that only five countries are signatories (including Brazil, Bolivia, and Uruguay), and only two of them have ratified (Venezuela and Mexico). Although the scope of applicability is defined and limited to States that are parties to the Convention, an argument may be made in contracts that have points of contact or close ties with other countries that are not parties to the Convention (for instance, a contract that has close ties with Mexico and the USA, which is not a party to the Convention). While this argument could sound risky, the Mexico Convention can still provide clear guidelines for the interpretation of internal choice of law rules and for the policy that Mexico is following on this matter. Based on this, it could still be argued that any clause that is consistent with the Mexico Convention does not constitute a threat against public policy, and therefore, should be enforced.

Before moving to jurisdiction clauses, it is important to point out that the Mexico Convention has also proved helpful in making a clear distinction between jurisdiction and choice of law issues, which will eventually help litigants with the conflict of law issues discussed previously. This comes from Article 7, which provides in the last paragraph that the "s*election of a certain forum by the parties does not necessarily entail selection of the applicable law*." Although it does not strictly follow from this provision that choice of law does not necessarily entail selection of jurisdiction, in an important way it does give clarity to the courts by distinguishing two different issues of conflict of law that at least merit different discussions and different reasoning in reaching a fair and correct solution to each problem.

Finally, in regard to jurisdiction clauses, we can also use the Hague Convention on Choice of Courts Agreements ("Convention on Choice of Courts") in helping us draft a better clause by providing insight into how the courts might react to these clauses or agreements. Mexico signed the Convention in September 2007, but it has not become effective because it has not been ratified. The EU and the USA also became parties (since early 2009), but ratification is still pending. As discussed in regard to the Mexico Convention, even if the Convention on Choice of Courts is still not binding over current matters, it will prove helpful in showing us what the policy is in Mexico regarding these issues. Any agreement that includes a jurisdiction clause consistent with the Convention will at least allow us to extend an argument that such a clause is to public policy.

In general, the Convention on Choice of Courts applies in international settings to "exclusive" choice of courts agreements in civil and commercial matters, reinforcing and confirming the jurisdiction of chosen courts, as long as the following conditions are met: (i) it is an exclusive choice (excluding jurisdiction for all other courts); (ii) the agreement is in writing; and (iii) the agreement is not illegal, pursuant to the law of the jurisdiction chosen. While the Convention only addresses the law from the jurisdiction of the chosen court (for purposes of determining the validity of the agreement), in scenarios where enforcement of a judgment will eventually be sought in Mexico, it would be wise to consider a couple of issues that are of concern under Mexican law.

- **What constitutes an express and voluntary choosing of jurisdiction?** In matters that are commercial in nature, and thus within the scope of the Commercial Code, Article 1093 provides that an *express submission* to the jurisdiction of a certain court will be recognized as long as the affected parties (i) clearly and conclusively renounce any other jurisdiction and venue afforded by law, and (ii) for purposes of future controversies appoint as courts with jurisdiction any of those relating to (x) the domiciles of any of the parties, (y) the place where the obligations are to be performed, or (z) the place where the thing is located (for actions *in rem*). In considering the adoption of a clause that gives exclusive jurisdiction to U.S. courts in a matter that has ties with Mexico, it is wise to make sure that the jurisdiction clause is clearly stated and that the parties expressly "renounce" the jurisdiction of the Mexican courts. A weak clause might allow the other party to move first and choose a state in Mexico as the proper forum, should the conditions under Article 1093 be met.

- **Are optional choice-of-courts clauses valid in Mexico?** Optional choice-of-courts clauses that operate exclusively to the benefit of one of the parties are deemed invalid, pursuant to Article 567 of the Federal Civil Procedure Code. These would be the type of clauses that give exclusive option to choose jurisdiction (among several stated forums) or arbitration to a specified and predetermined party to the transaction, such as the creditor, the seller, Company "X", etc. To avoid any such conflict it would be wise either to give any such option to both parties ("any party acting as plaintiff"), or to avoid the optional clause entirely. It is hard, but sometimes we have to recognize that we can't have the best of both worlds.

### E. Statute of Limitations

A key issue in pursuing international commercial claims is what is the applicable statute of limitations. While the jurisdiction of the debtor is a critical consideration, what about rights created by the contract entered into in another jurisdiction where the time period may be longer and in favor of the creditor?

Since 1988, Mexico is a party to both United Nations Conventions on Contracts for the International Sale of Goods ("CISG") and Limitation Period in the International Sale of Goods ("Convention on Limitation"). Thus, in commercial transactions where the parties are sitting in different countries that are signatories to the CISG and to the related Convention on Limitation, the statute of limitations will generally be four years. In cases where these treaties do not apply and where Mexican law is the clear choice of applicable law, either because all parties are located in Mexico, because the parties agreed to such choice of law, or because there is no controversy to that effect in general, then the law applicable to address *prescription* (limitation) is the Commercial Code (for transactions that are commercial in nature) and the Civil Codes (for transactions outside the scope of the Commercial Code). In general, the period of limitation in most situations is ten years, with some exceptions that reduce that period—in specific settings—to five years and two years, the most important of these settings being torts, where a two-year limitation period is provided.

But the challenge is in situations where the CISG or the Convention on Limitation does not apply and the underlying transaction or event has points of contact or close ties with more than one country (including Mexico). Here, the matter turns into a conflict of law issue, and because prescription (limitation period) is considered in Mexico a matter of *substantive law*, as opposed to being a matter of procedural law (as in other countries generally from the common law tradition), then the matter must be settled according to the rules on choice of law that apply to the underlying transaction/event. In controversies where Mexican law on limitation is confronted with that of another jurisdiction where limitation is considered a matter of procedural law, Mexican law should prevail and the general or exceptional limitation periods pointed out above would apply. But in situations where the conflicting jurisdictions all treat limitation as a matter of substantive law, then a solution is not clear beforehand and we would have to refer to Mexican rules on conflict of law to solve any matter at hand, either to the Mexico Convention pointed out before, should the controversy arise out of a contractual obligation, or to other rules from the (Federal) Civil Code or from the 1979 Inter-American Convention on General Rules of Private International Law (the "Montevideo Convention"), should the origin of the controversy not be contractual. (For more information on conflict of law please refer to our discussion on choice of law and jurisdiction clauses, as well as forum shopping.)

### F. Damages

Assuming that the claim goes forward in a legal proceeding, what amounts can be claimed as damages? Issues such as attorney's fees, administration and collection charges, and, in some jurisdictions, the items of interest and court costs should be considered.

Mexico's legal system follows a slightly similar pattern than the one in the USA in terms of attorney's fees and court costs (hereinafter referred jointly as "costs and fees"). Just like the "American Rule," the rule in Mexico is that each party is responsible for its attorney's fees, but there are several exceptions to the general rule, where the losing party will pay the winner not just attorney's fees but also court costs and general expenses of the litigation. In commercial litigation, a Mexican court will usually award such costs and fees to the party who has litigated in bad faith, which may be in cases where false evidence is offered and introduced, or when a party fails to produce any evidence whatsoever to support its defenses or claims. Costs and fees are also awarded to a winning party in an executive type of proceeding.[2] In all other cases, the winning party is awarded costs and fees when he wins the case in first instance and the judgment is appealed and confirmed in all parts. (A further note on attorneys' fees is in regard to regulation, that is, how much can parties be awarded, was discussed initially under Part IIA, "Fee Structure." Please refer to that section for additional information.)

In terms of interest, Mexican law allows parties to agree on whatever percentage is in their best interests, without any statutory restriction other that being moderately fair and not so disproportionate that it could be presumed that it was a result of one of the parties being taken advantage of because of urgent necessity, inexperience, or ignorance.[3] Parties can agree to and ultimately demand, simultaneously, a general or fixed interest fee (finance charges), as well as a late interest fee (penalty charges). If parties do not agree to finance charges beforehand, it will be deemed that the loan or credit is free of charge and they will not be allowed to claim any finance charges as damages. However, when parties don't agree

to late interest beforehand, they are allowed to claim them as damages during litigation, but these will be limited to the statutory (legal) late interest fee. The legal late interest for transactions that are commercial in nature is six percent per year. For all other transactions the legal late interest will depend on the Civil Code of each state, ranging usually from six to nine percent per year.

Mexican law—in both state and federal jurisdictions—recognizes *actual* as well as *consequential* damages in most settings (torts, contracts, etc.), and will award them as long as they are properly claimed in the initial brief of complaint. These damages can be proved during the proceedings (before trial), or after judgment has been rendered with a damages award. Penalty clauses in contracts are also recognized under Mexican law, but their nature is compensatory (such as liquidated damages clauses), that is, to compensate for any actual and/or consequential damages rather than to punish. These clauses will be recognized and awarded as long as they do not surpass the amount provided as the main obligation in the contract. Finally, punitive damages are not recognized or provided under Mexican law and will not be awarded. Because of the compensatory nature of damages in the Mexican legal system, it is doubtful that a Mexican court will recognize and enforce a foreign judgment that includes an award for punitive damages. It might homologate the judgment and enforce it partially, setting aside the part relating to punitive damages. This, however, is not set in stone, and a plaintiff might make an argument for enforcement that defeats that of the defendant.

It is important to keep in mind that Mexico is a party to the CISG. Thus, under the CISG, Mexican courts will recognize all the remedies for buyers and sellers under articles 45 and 61, including damages pursuant to Articles 74 through 77, and interest pursuant to Article 78. This applies, of course, to sales transactions that are "international" in nature, where the parties have their domiciles in different countries that are parties to the CISG.

### G. Guarantees

Personal guarantees allow creditors to extend credit. However, the question is whether such guarantees are enforceable—no matter how well drafted. Is it necessary that it be a separate document, or can a guarantee be included in a commercial credit application? Are there formalities, such as authentification, that might be necessary to give it effect?

In drafting a personal guarantee that is to be enforced in Mexico, special attention should be given to the choice of law that is to govern such an agreement. If the guarantee is to be included in the credit application (which is valid and acceptable), a creditor will want to make sure that the governing law that is to apply to the transaction is Mexican law. If the transaction takes place in Mexico and the effects are limited to within Mexican territory, Mexican law will automatically govern based on Mexican *conflict of law* rules,[4] unless a valid choice of law clause provides differently. Under this scenario, Mexican law does not require any kind of formality to be met in order for the guarantee to be valid and have full binding effect upon the parties (not even that the guarantee be made in writing). Nevertheless, a few suggestions are in order.

Even when Mexican law does not require for the personal guarantee to be made in writing, for practical reasons and in anticipation of litigation, we cannot stress enough that the agreement should be in writing. The same goes for signature or ratification before a Notary Public. This is not required by law, but it is heavily recommended for the sake of avoiding time-consuming and risk-elevating evidence such as expert witnesses in handwriting and signature analysis, which would be required in cases where parties deny any signature thereof. Thus, whenever possible, a ratification of the guarantor's signature should be requested before a Notary Public, for assurance. Authentication is not required unless the ratification occurs before a foreign Notary Public.

In terms of content, three things stand out:

- **Type of guarantee**. It is highly recommended that the agreement is worded to commit the personal guarantor as a joint obligor by including a statement whereby the guarantor waives any right to second order of litigation after the main debtor has been sued ("*beneficio de orden*"), and to the exclusion of seizure of assets until after execution against the main debtors has been done ("*beneficio de excusión*").[5] Otherwise these concepts could lead to delays in executing against any of the debtors, whether primary debtors or personal guarantors.
- **Identification of main obligation**. Because the personal guarantee agreement might be contained in a different document from those relating to the terms of sale or the main contract or transaction, specific and clear reference needs to be made to the obligation or set of obligations that is being guaranteed, including reference to any past, current, or future obligations or transactions (such as sale of goods based on a credit line), to avoid exclusion of any such obligations.
- **Nature of guarantor and authorization thereof**. Corporations (legal entities) can also act as guarantors, as long as the granting of guarantees is authorized and expressly included within the corporate purpose of the entity (as per the *ultra vires* principle), whether in the articles of incorporation or its bylaws. If a corporate guarantee is to be requested from a Mexican corporation, it is a good idea to check its corporate documents to make sure that the act of guarantee will be a valid one as authorized under the corporate purpose.

Should the transaction have close ties (or points of contact) with another country and there is potential that such law will govern, either entirely or in part, creditors should analyze the different alternatives in conflict of law rules to make sure that there will be no risks in enforcing the guarantee in Mexico. Such a situation would be, for instance, where the guarantee is signed and/or executed in a foreign country. Under Mexican conflict of law rules, absent a provision or clause making Mexican law the applicable choice of law, such a guarantee agreement would have to meet the formalities provided under the laws of the foreign country, and this would be examined by the Mexican courts should such a challenge or objection be made by the litigants. Therefore, it is a good idea either to meet the forms provided under the laws that will potentially govern the agreement, or to include a choice of law clause that refers controversies on interpretation to the law of the state where the potential for enforcement is greater.

## H. Forum Shopping

When a decision has been made to proceed with a particular legal action in regard to an international transaction (one where parties or assets are located in different countries, or where elements of the transaction are governed by laws of different countries), there are many factors to consider in choosing the best forum as plaintiffs, that is, one that will provide a strategic advantage in court. The key factors in such a decision are not just to win the case, but also to execute and collect on any resulting judgment effectively and without delay. The following is a list of issues that should be evaluated in regard to potential lawsuits in Mexico. These come from the particular traits of the Mexican legal and court systems, and should be weighed against the issues arising in other available forums. (Additional issues from the perspective of the Mexican forum are also evidenced from the rest of our discussion throughout this article.)

**1. Does the Mexican legal system afford parties the legal and/or equitable remedies available in your country?**

**(a) Equitable remedies.**

Mexico does not recognize within its legal system the equitable remedies generally available in common law countries. Thus, the injunction remedy will not be available as an equitable remedy backed up by the power of contempt. Nor is there any other legal remedy that is as effective or comparable as the injunction, acting *in personam*. The remedy for specific performance acquires a different legal nature, where the court will compel the debtor to perform on the contract based on its obligation to perform a specific act or service. Failure to comply could result in criminal liability, but more generally will result in an award for damages. The remedy of restitution under the unjust enrichment doctrine is very limited in scope, with no presence of the specific remedies of constructive trusts and equitable liens. Therefore, "tracing" of property is limited and ineffective (and contributing to the ineffectiveness is the lack of equitable contempt power), and there is no priority over other creditors.

**(b) Piercing the corporate veil.**

There is no fixed recognized *alter ego* doctrine that allows effective relief for piercing the corporate veil. A creditor who has found out that the debtor has commingled assets with the intention of turning its debtor company bankrupt (while illegally transferring the profits to another controlled company) will either have to sue through a myriad of civil actions for nullity (simulation) and civil fraud, or will have to file a criminal accusation before the prosecutor for the crime of fraud. Neither of these remedies is efficient or effective, and courts are not used to dealing with these matters, which will set the tone for the struggles ahead.

**(c) Legal remedies.**

Remedies that are legal in nature, including damages, will be recognized in Mexico. However, punitive damages are not recognized under Mexican law and enforcement of a foreign judgment that awards them is questionable. Penalty clauses are valid and can result in an award, but their nature is more of a liquidated damages clause, and thus, should be considered as such. For more information please refer to Part II.F on damages, discussed previously.

**2. Do the facts in the matter and the evidence supporting it make for a strong case, based on the particularities of the Mexican legal process?**

**(a) Pre-trial discovery.**

Pre-trial discovery is not recognized in the Mexican legal system. Consequently, additional evidence in the defendant's control or possession (such as documents or information through depositions) will not be available before the filing of the initial complaint brief. Adding to the harshness on plaintiffs is the fact that there is no opportunity to amend an initial complaint. Thus, facts have to be pleaded with particularity in order to support any stated claim and provide full opportunity to a defendant for producing arguments and defenses. This means that a plaintiff will have to be ready from the outset with a strongly argued case (stating its claims with supporting detailed facts), and with good and reliable supporting evidence (especially documents) to prove such a case effectively.

**(b) Jury trial.**

Mexican judicial procedure does not contemplate jury trials. Thus, the judge will always be the trier of fact. Evidence will be considered and weighed at the end based on a mixed system of law and free but reasoned evaluation of fact, as specifically provided by law. Thus,

room for persuasion on the facts is limited, based on what the law affords the litigants. Nonetheless, the judge is required to give a reasoned opinion as to how the facts were determined.

**(c) Standard of proof.**

In civil and commercial cases, the judge must rule based on an "intimate conviction" of the facts. That is, for the judge, the facts will have to be fully proved. This contrasts with the usual standard of preponderance of evidence from common law countries (for civil cases), which provides grounds for some attorneys arguing that the standard is higher in Mexico. Although the Mexican legal system appears to be built for this approach based on the responsibilities of the trier of fact (from the mixed system of evaluation of evidence, as discussed above in the preceding Part II.H.2(b)), it is in a way harder to meet that standard in many cases where documentary evidence is missing.

**(d) Witnesses.**

Witnesses may be a key part of the adversary system under the common law, but they carry much less significance in Mexico. Reasons may be found both in theory and practice. First, two witnesses will always be necessary in civil cases to prove any stated fact. One witness will carry no weight unless both litigants (jointly) offer him as their witness. Second, a hostile witness will rarely help build your case, as extracting truth out of cross-examination is much harder, based on many factors, including the intermediate and supervisory role of the judge or secretary (which disrupts the flow of questioning), and the prohibition of asking leading questions to these hostile witnesses. Therefore, either you bring two good witnesses to the case that you can call, that are not hostile, and which statements do not constitute hearsay, or you will have to bring key documents that will help bring a strong case.

**3. Are the Mexican courts the best suited to hear your complex case?**

As explained before,[6] many courts in Mexico still follow a territorialistic philosophy, which creates problems in interpreting or applying foreign law. This situation is more common than one would imagine, and it merits serious consideration. While there are many judges that welcome these cases (and the challenges that they present), there are other judges who will simply ignore foreign or international law (like the CISG). Others will apply foreign law to the best of their knowledge, with usual disregard upon interpretation to its international character and the obligation to promote uniformity in its application. But the worst case is where some judges look to get away with the responsibility, and thus, will look for ways to get rid of such cases through deficiencies in jurisdiction or choice of law clauses, powers of attorney, etc. Since this situation varies widely from jurisdiction to jurisdiction, consultation with local counsel is of outmost importance to determine the best strategy as to forum.

**4. How difficult will it be to enforce a foreign judgment in Mexico?**

**(a) Treaties.**

Multiple international treaties regulate enforcement of foreign judgments and make the process more predictable. Since 1984, Mexico is a party to both the 1979 Montevideo Inter-American Convention on Extraterritorial Validity of Foreign Judgments and Arbitral Awards (hereinafter the "Convention on Foreign Judgments") and the 1984 La Paz Inter-American Convention on Jurisdiction in the International Sphere for the Extraterritorial Validity of Foreign Judgments (hereinafter the "La Paz Convention"). As of this date, the La Paz Convention has really not been supported by any countries other than Mexico and Uruguay. The Montevideo Convention on Foreign Judgments *has* been signed by several countries of the OAS, with the absence of Canada and the United States. As usual, the Conventions come into play only when the judgments to be enforced come from a country that is also a party to such treaties. Thus, enforcement of judgments from Canada, the USA, or any other country around the globe outside of Latin America, will not be governed by such rules. Instead, it will be Mexico's local procedure laws which will set the standards and the specific procedures for recognition.

**(b) General process.**

The general process of homologation and enforcement of foreign judgments is complex and carries many risks to those parties that seek enforcement. In light of the extensive discussion that this topic merits, we would recommend obtaining full information by referring to a specific paper on the topic at www.hmhlegal.com/avoidingpitfalls.htm.

**(c) Jurisdiction.**

Before finalizing this discussion, we believe jurisdiction to be so important for enforcement that we will touch on it again. In this connection, there is a key question creditors considering suing Mexican debtors abroad should ask themselves: Did the debtor expressly submit to the jurisdiction of the foreign court (through a verbal or written agreement), or did the debtor at some point in time have a domicile in that foreign country whereby the foreign court assumed jurisdiction? If the answer to this question is "no," it is wise to think twice before embarking on litigation abroad, if the ultimate plan is to execute upon the debtor's assets in Mexico. Local procedure laws in some states provide such grounds for jurisdiction (express submission or domicile) as a precondition for enforcement. Although this precondition is not provided under federal civil procedure law, it is an open question whether homologation of foreign judgments in Mexico is

a matter of federal or local jurisdiction, and thus, whether federal or local law should be applied. This issue can be argued either way, but nonetheless, it carries a great risk, since the argument of jurisdiction will probably be introduced by a defendant, regardless of whether the matter of homologation is considered federal or local.

## I. Service of Process

In making a decision on how to make service of process upon a defendant located in Mexico in aid of foreign legal proceedings, it is prudent to ask two questions to determine the best strategy: (i) whether the defendant has assets in Mexico; and (ii) whether the foreign legal proceedings are being followed through a judicial court or through arbitration.

If no enforcement will eventually be sought in Mexico, there may be no need to comply with Mexican procedural rules for service of process, unless the procedural law that governs the foreign proceeding so provides. If at least substantial formalities are required by the foreign law, then the options provided below will be helpful. Otherwise, you may want to stick with the simpler process (probably by private process servers), since the official methods provided below and available through the judicial system and the central authorities are troublesome and lengthy, which will surely delay your proceedings abroad.

If enforcement of that foreign judgment or award *will* eventually be sought through the Mexican courts, then consideration of the official methods for service of process is highly recommended. Although Mexico's Federal Code of Civil Procedure, in regulating the process of homologation and enforcement of foreign judgments, does not explicitly provide as a precondition for enforcement that any service of process done in Mexico must strictly comply with the formalities provided under local procedure rules, it does provide as a precondition that the request or petition for enforcement be supported by authentic documents that prove that personal service of process was properly done. This evidences that the defendant was afforded its procedural due process rights (as provided under the Constitution) as well as full opportunity to argue and defend its case.

Under these premises, a strong argument can be made that the proper way to satisfy essential service of process requirements, so as to afford procedural due process rights, is only though the judicial courts, subject to the specific procedure rules governing such courts. In regard to arbitration, the argument is much weaker, since by agreeing to the arbitration clause (and to the arbitration process in general), a counterargument exists that the parties agreed that the specific procedure for service of process was the one provided under the rules for such arbitral proceedings, which, in the case of Mexico, is allowed by private process servers or even by certified mail. Thus, meeting the strict formalities under Mexican law is more a recommendation for judicial proceedings than for arbitration.

Should a decision be made to execute the service of process through the Mexican courts and to satisfy the formalities provided under Mexican procedure laws, the best way to make sure that this is done properly is by making a formal request from the foreign court through letters rogatory. Mexico is a party to the 1965 Hague Convention on the Service Abroad of Judicial and Extrajudicial Documents in Civil or Commercial Matters since 2001 (hereinafter referred as the "Hague Convention on Service"), and to the 1975 Inter-American Convention on Letters Rogatory as well as its 1979 Additional Protocol, both since 1979 (hereinafter the "Inter-American Convention on Service"). If the foreign court is a party to any of these treaties, it is wise to channel the service of process through the methods provided therein. Otherwise (non-party countries), the letter rogatory from the foreign court should at least comply substantially with the information provided under these Treaties.

There are two things that stand out from both these Conventions on Service. From the Hague Convention, Mexico has confirmed through reservations that private process servers will not be authorized to proceed with notifications, nor will notification by mail or by foreign judicial or police authorities be authorized, as provided under Article 10. However, Mexico does authorize for service of process or notifications to be executed directly through consular authorities (avoiding the need to channel the letters through the central authorities), although limited to notifications of foreign nationals, as per Article 8. The Inter-American Convention also has another advantage in allowing the same litigant parties to transmit the letters rogatory directly (by themselves), thus, avoiding the lengthy and troublesome process through the central and consular authorities. When this method is chosen, authentication and legalization of letters are required, but the Inter-American Convention gives further discretion to courts situated along the border to waive the legalization requirement, as per Article 7. This is of utmost importance because of the difference in practices of authentication and legalization of documents between the Latin American countries, and those of other countries, including the USA and Canada. This method of directly delivering the letters by the litigant parties is also advantageous because it allows a party's attorney to monitor the process closely with the local courts to make sure that there is no unjustified delay. In this sense, involvement of local counsel is key.

Finally, although the service of process procedure for arbitration if fairly simple and straightforward (even authorized by certified mail), it is prudent to try to reinforce it with good evidence to avoid any merit to a future challenge. This can easily be done by retaining local counsel

to do the service of process while complying substantially with the formalities provided under Mexico law and with the help of a Notary Public (or Commercial Broker), who can attest to the details and the particularity of the service, as well as to the formalities undertaken therein. With this, risks of potential challenges against the service of process will be minimized upon enforcement of the arbitral award.

### J. Local Counsel

Before embarking on a lawsuit against a foreign debtor or in the jurisdiction of the creditor, it is prudent that the creditor contact local counsel in Latin America in order to obtain important information such as the correct corporate description of the debtor, what type of service and notification is recommended, and what will become necessary to enforce a foreign judgment in that jurisdiction.

A strong relationship with local counsel will always be key in making the best decisions for legal action because every consideration of alternative forums of dispute resolution requires local knowledge not only of the laws, but also of current practices in the court system that abide or deviate from the strict rule provided under the laws. I believe this insight can only be provided by local counsel who specializes in these issues and deals with them in the courts on a day-by-day basis. Without a doubt, the endeavors of the International Section of the New York State Bar Association will prove successful in creating the relationships necessary for elevating the quality of the legal services in this new globalized world.

## Endnotes

1. A few years ago (2005) there was a case in a civil court in Tijuana that involved the application of the UN Convention on Contracts for the International Sale of Goods (CISG). Following final arguments, as I was discussing the case with the judge in chambers and suggesting ways of interpreting the CISG, he stopped me abruptly at one point and in an exasperated way rebutted: *"I will only apply Mexican law in my court, and that is final."* Just as many judges before him, he was being very localistic and proud of defending national sovereignty by not allowing strange and foreign laws in his courtroom. Little did he know that the CISG was also part of Mexican law. Another case that comes to mind is one from the Superior Court for the State of Baja California (2003). That case involved a contract that contained a governing law clause along with an "optional" arbitration clause. Both pointed to North Carolina (USA), and nothing was provided in terms of jurisdiction. The defendant had its domicile in Tijuana, where he continued to do business and had assets (with no presence anywhere else at any time), so jurisdiction was effective for the Tijuana courts based on Mexican commercial procedure law. Jurisdiction was challenged by the defendant, and the Superior Court (acting as a court of appeals) ruled in his favor. In the opinion, the court said that "*a case can only be heard by a judge that has jurisdiction in the territory where the applicable law is binding over the matter at hand*." Because that case involved North Carolina law as the choice of law, the Court reasoned that it was a North Carolina judge who should hear the case. The decision was confirmed by a Federal Circuit Court in a final Amparo proceeding.
2. The *executive proceeding* is a specific type of proceeding in Mexico that is afforded to plaintiffs who hold special title for execution (*título ejecutivo*). The executive proceeding provides many advantages to creditors over the *ordinary proceeding*, which is the regular proceeding that plaintiffs have to follow if they lack title of execution or a specific guaranty for enforcement (such as mortgages, security interests, or pledges). First of all, the special title on which the proceeding is based creates a presumption that the claim exists and that it's legally valid, which turns the burden of proof on the defendant. Second, the same title gives a preliminary certitude of the plaintiff's claims, allowing an immediate *ex parte* prejudgment attachment order without placing bond. Third, it is rather a summary proceeding in which evidence admission and proposals are limited to the initial stages through the complaint and answer's briefs. This makes for a shorter and faster proceeding in which a final resolution is usually going to be rendered in less time.
3. This is provided under Article 2395 of the Federal Civil Code, and reproduced in most states' codes. That same provision authorizes the judge, under such circumstances of disproportionate high interest and acting in "equity" (or "equality"), to reduce the agreed interest fee to the legal interest fee, as provided under the Code. Although the provision is very subjective, it is hard to prove such disproportionality, and courts are reluctant to grant relief based on such defenses or claims, especially in commercial settings where there is a high presumption that the parties know the business and therefore knew, or should have known, what they were doing.
4. Reference for Mexican conflict of law rules is to be made to the Federal Civil Code, specifically, Articles 12, 13, and 14. The Mexico and the Montevideo Conventions are both consistent with the Civil Code rules, and would apply in cases involving other States (along with Mexico) that are parties to the Conventions.
5. Joint obligations and rights of order and exclusion are provided for under Articles 1987, 1988, 1989, 2814, 2815, 2816, and 2822 of the Federal Civil Code.
6. See Part IID *supra* on jurisdiction and choice of law.

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# Commentary: Overcoming Language Traps in Depositions of Chinese-Speaking Witnesses

By Geoffrey Sant

## I. Introduction

In recent years, there has been an explosion of lawsuits against Chinese companies. For example, lawsuits against Chinese reverse merger companies tripled between 2010 and 2011, and litigation against Chinese companies represented 47.9 percent of all securities class action filings for the first half of 2011.[1] The upward trend of U.S. litigation against Chinese companies has been continuing for years.[2]

As litigation increases, there is a corresponding increase in the number of depositions of Chinese-speaking witnesses.[3] A deposition, of course, is an opportunity for counsel to obtain admissions intended for "later use in court."[4] As discussed below, however, when an attorney conducts an English-language deposition of a Chinese-speaking witness through a translator, there is a near certainty that significant miscommunication will occur. Admissions may be lost due to mistranslation, or innocent statements may be interpreted incorrectly as admissions. In either case, the result can be devastating.

## II. Chinese-Language Testimony Is Susceptible to Mistranslation

### A. Generally

Let us consider a real-life example. In a recent deposition, I questioned a hostile witness regarding an important conversation that he denied had ever occurred. When I pressed him as to whether it was possible that he had forgotten about the conversation, he responded in Chinese, "*tai yuan*, *tai yuan*." Literally, this means "too far, too far." The interpreter then translated this answer as "You're too far off. Too far off." Although the interpreter's words were one legitimate interpretation of the deponent's answer, I knew that in Chinese, there was another possible meaning—namely, that the deponent was acknowledging that the events occurred "too far" in the past, and thus the deponent was agreeing with me. By following up with further questions, I established that this was, in fact, the case: the deponent was agreeing with my suggestion and not denying it. Here, the miscommunication was total. A "yes" transformed into a strong "no."

This example is just the tip of the iceberg. Chinese verbs do not conjugate, and so do not necessarily distinguish between present and past tense. Chinese nouns generally do not have singular and plural forms; and spoken Chinese does not distinguish between "he," "she," and "it"—if a phrase uses pronouns at all. Interpreters must make assumptions about the speaker's intended meaning repeatedly throughout the deposition, and some of those assumptions will likely be wrong.

### B. Some Examples

To better see the problem, let us consider a couple hypothetical Chinese-language utterances and an English-language statement.

#### 1. *You ren tou ta-de che*.[5]

This sentence would likely be translated as "Somebody stole his car." Such a translation is so natural that even a native Chinese speaker may not recognize its assumptions and problems. In reality, every single word in this translation is making an assumption—and each assumption may be wrong in its own way. First, Chinese does not necessarily distinguish between time frames, and so it is unclear whether the speaker is saying that somebody "stole" (past tense) or "is stealing" (present tense). Furthermore, because Chinese generally does not distinguish between singulars and plurals, the speaker could be saying "Somebody is stealing…" or "*Some people* are stealing…" In fact, it is even possible that the thieves are stealing multiple cars. Lastly, it is unclear whether the speaker is saying that "his" or "her" car is being stolen.

#### 2. *Dang-ran dou zhi-dao*.[6]

This statement—likely to come in answer to a question at a deposition—is even trickier. The most obvious translation might be "Of course he knew everything." Once again, however, such a translation requires a laundry list of assumptions. For one thing, like a number of other languages, Chinese does not require a speaker to mention an explicit subject, and it appears this sentence does not have one. Thus, it is unclear if the speaker is saying "he," "she," or "they" knew everything. But there is actually yet another possibility. Although the word "*dou*" would probably be interpreted as the object of the verb ("…knew *everything*"), it could also be interpreted as the subject ("*all of them* knew…"). Additionally, as discussed above, it is not clear whether the verb "to know" should be in the present or the past tense.

To this point, we have seen two examples of how Chinese is ambiguous and susceptible to multiple, distinct meanings in English. This not only occurs when a Chinese statement is translated to English, but also when an at-

torney's English-language statements are translated into Chinese. Consider the following example.

### 3. Did the boss know?

This might be translated as "*Lao-ban zhi-dao ma*?" But this Chinese translation renders ambiguous both the time frame and the number of bosses under discussion. Thus, the deponent could easily interpret the Chinese translation of this question as "Do your bosses know now?" rather than "Did the boss know [then]?"

Let us examine how these ambiguities play out in a hypothetical exchange in a deposition. The questioner asks "Did the boss know?" and it is translated as "*Lao-ban zhi-dao ma*?" The deponent then misinterprets the Chinese translation as asking, "Do your bosses know now?" The deponent responds with the ambiguous phrase discussed previously: "*Dang-ran dou zhi-dao*." ("Of course everyone knows." / "Of course he knew everything.") The translator then interprets this answer as, "Of course he knew everything." In this case, the deponent is merely acknowledging that the bosses now know about the event being litigated (because they have been sued), but this innocent answer is transformed into a devastating admission that a specific boss knew everything at a specific time in the past.

## III. Real-Life Examples of Critical Mistranslated Chinese-Language Testimony

For an actual example of this kind of miscommunication through a translator, consider *He v. Ashcroft*.[7] In *He*, both the original Immigration Judge and the Board of Immigration Appeals rejected as "not credible" an asylum petition by an individual named Wang He.[8] The main episode singled out as "not credible" was Mr. He's description of over ten men driving up and jumping out of a single vehicle. The problem here is that Chinese does not normally distinguish between singulars and plurals, and it appears likely that Mr. He did not actually mean to express that these individuals all jumped out of one car: rather, it appears that the interpreter initially translated Mr. He's reference to vehicle(s) as "a car" and then continued using the singular to translate Mr. He's references to vehicle(s) even after it became apparent that there must have been more than one.

The problem began when Mr. He states (according to the translator), "I saw [a] few people jump out of the car." Because Chinese does not distinguish singulars and plurals, the interpreter guessed that Mr. He referred to only one. The following exchange then occurred:

> Q: How many people together were there, coming in that car?
>
> A: At that time, I was in [a] hurry. Seems like more than ten, or ten some people.

At this point, it already appears that the interpreter's translation of both "few" and "car" were poor choices. Nevertheless, the interpreter continues using the singular to translate the Chinese term for "vehicle(s)" even as an incredulous judge repeatedly asks Mr. He to confirm that ten or more people arrived in a single car:

> Q: Ten people in the car, more than ten people you said?
>
> Q: So there were ten people. But, how many people in the car? Can you tell me again?
>
> Q: But, you're sure it's more than ten?

The Immigration Judge is clearly asking Mr. He to confirm his strange description of ten or more people jumping out of a car. But once translated into Chinese, the import of the judge's questions is lost. For example, "Ten people in the car, more than ten people you said?" becomes in Chinese, "Ten people in the car(s), more than ten people you said?" It appears, then, that an asylum petitioner was initially deemed "not credible" primarily because the interpreter made unfortunate guesses as to the speaker's intended meaning.

In *He*, the problem appears to have been that the interpreter refused to correct her translation even after it became apparent that her initial translation was probably wrong. In other cases, the opposite problem occurs. Sometimes interpreters will translate the same English word in different ways on different occasions during the same deposition. This can happen because the interpreter is trying to "fix" an earlier translation, or because the interpreter forgot the way the word was initially translated. Sometimes this happens even in back-to-back questions. In English, this would not be permitted: if the deponent stated that he "seldom" came to work late, and the follow-up question asked about "often" coming to work late, the defending attorney would object that this misstates prior testimony. Yet when interpreters make this sort of linguistic change, it often goes unnoticed.

The susceptibility of Chinese to multiple interpretations is evidenced by a recent case in which my client was sued for alleged breach of contract. The plaintiff presented a translation of the key contract. We presented an opposing translation (and also highlighted problematic aspects of the plaintiff's translation). The plaintiff then submitted a new translation performed by a new translator. The end result was three differing translations, by three translators, two of them for the same party.[9]

For yet another example of the problematic nature of translating Mandarin Chinese depositions, consider *Max Impact, LLC v. Sherwood Group, Inc.*[10] In *Max Impact*, a Chinese-speaking vendor who manufactured products for both the plaintiff and the defendant was a crucial

third-party witness to patent and copyright infringement claims. Although the court recognized that this third-party manufacturer was "the person best situated to know" whether infringement occurred, the court entirely disregarded his testimony due to contradictory deposition answers: "It is unclear whether [his] testimony is compromised by the translation process.… What is clear is that [his] testimony is inconsistent, and this Court need not give it much weight."[11]

The court reached this decision even though the third-party witness had submitted a declaration stating that the testimony *had* in fact been compromised by the translation process: "[he] either misunderstood the question based on the translation or [his] response was not translated correctly."[12] The result was that the plaintiff lost its leading witness for infringement and the court denied a preliminary injunction for lack of evidentiary support.[13]

How then can parties avoid or minimize translation problems in depositions? Parties defending a deposition should consider bringing their own translator (a "check translator") to double-check the translations of the purportedly neutral interpreter. Some courts even assert that parties "are responsible for providing competent translators in order to participate effectively in [the] litigation, including for their [own] depositions."[14] However, it is not enough to simply bring along check translators and assume that they will catch any errors or ambiguities. As discussed above, in the majority of translation problems, the interpreter's translation is valid (as one legitimate interpretation of the deponent's words) and nevertheless incorrect (because it was not the deponent's actual intended meaning). In these circumstances, the check translator would have no reason to think the translation was objectively "wrong."

The best practice is to work with check translators ahead of time to ensure that they understand each side's theory of the case, as well as key contended issues. This way, the check translator can be on guard to react when ambiguous testimony is translated in a harmful way.

For attorneys on both sides, it is useful to consider carefully how the following differences between the Chinese language and English might affect deposition testimony.

1. *Time Frame*. Verbs do not conjugate in Chinese.[15] It is possible for a questioner to be clearly discussing the past while the deponent thinks the question refers to the present, or *vice versa*. Attorneys should think ahead of time about what aspects of the case revolve around timing (*e.g.*, statute of limitations defenses). Attorneys taking depositions can largely avoid timing ambiguities by using subordinate clauses to specify the exact time period as part of the overall question (*e.g.*, "At the time you were working there…"; "Last year…"; etc.). This is the way that Chinese-speakers clarify time frame in conversation; by doing it in English, the questioner can limit ambiguously translated questions and answers.

2. *Numbers*. Nouns do not distinguish between singular and plurals. Attorneys should keep in mind what aspects of the case involve the number of things or the number of times events occurred.

3. *Pronouns, Possessives, and Adjectives*. Spoken Chinese does not distinguish between "he," "she," and "it" or between "his," "hers," and "its." The attorney taking the deposition can often avoid confusion by identifying the individual being discussed by name. Additionally, the Chinese word *shei* can be troublesome because in different contexts it can mean anything from "who" to "whoever" to "anyone." Another tricky word is the adjective *qita* (其他), "other." Because Chinese generally does not utilize articles (such as "the" or "a"), it can be unclear whether *qita* means "the others," "any other," or "another."

## IV. Other Practical Considerations

When depositions are conducted through a translator, it is wise to look up the opposing attorneys' law firm biographies ahead of time to ascertain their Mandarin language skills, if any (which are almost always listed).

An attorney intending to object to translation may need to have the deposition recorded. Without a recording, it can be difficult to object to translation in a manner that provides the court with a full record. For example, the attorney may need to put ambiguous Chinese words on the record through phonetic spelling, or to make objections that explain Chinese grammar. Yet in two recent cases, Chinese-fluent attorneys were sanctioned for making "lengthy interruptions" and "speaking objections" during attempts to put translation problems on the record.[16]

Another issue is the difficulty in obtaining full answers from deponents. Interpreters sometimes skip portions of the answer, or worse, paraphrase. In one recent case, the defendant alleged that "during the first hour of the deposition, on at least two occasions, [the Mandarin translator] left out part of [the deponent's] answer..."[17] The flip side of this problem is that deponents often stop in the middle of a lengthy answer give the interpreter a chance to translate what has been said up to that point, only to create the mistaken impression that the deponent finished answering. The questioning attorney may then start asking the next question. Attorneys should be aware of this problem and, where appropriate, confirm that the deponent has finished answering before continuing.

Attorneys taking a deposition may wish to prepare bilingual Chinese and English definitions of key terms ahead of time, in order to avoid purported linguistic ambiguities and disputes over translations.[18]

Finally, when working with a check translator, an attorney may wish to prepare a list of translation-based objections. This will allow the check translator to simply point at the problem area, so the attorney can quickly register an objection without it devolving into an improper speaking objection.

## V. Conclusion

Linguistic preparation is key in Chinese-language depositions. Without linguistic preparation, an attorney may be confronted with "admissions" and "denials" that the deponent never intended. By preparing ahead of time, a defending attorney can force opposing counsel to make sure all questions and answers are unambiguous in both English and in Chinese—a very challenging task.

Although this discussion is far from an exhaustive list of all the linguistic challenges facing attorneys in Chinese-language depositions, one thing is clear: linguistic preparation is *unambiguously* helpful.

## Endnotes

1. *See* Cornerstone Research and Stanford Law School Securities Class Action Clearinghouse, *Securities Class Action Filings: 2011 Mid-Year Assessment* 13 (2011).
2. *See* China Court, *Mei-lu-suo ding-shang Zhong-guo Zhong-guo zai-mei shang-shi gong-si pin-pin bei-gao* [American law firms have their eye on China, US-listed Chinese companies are being sued frequently] (2 Feb. 2009), http://www.chinacourt.org/html.article/200902/02/342482.shtml (last visited 27 Nov. 2011).
3. As just one example of this trend, see *In re LDK Securities Litig.*, No. 07-5182 (WHA), 2010 U.S. Dist. LEXIS 87168, at *10-11 (N.D. Cal. 29 July 2010) (describing "translations of documents and interpretations of depositions in Chinese" of such quantity that the translation cost alone amounted to nearly half a million U.S. dollars). The term "Chinese" throughout this article refers to Mandarin Chinese.
4. Black's Law Dictionary 505 (Bryan A. Garner, ed., 9th ed. 2009).
5. One possible rendition of this statement in Chinese characters is: 有人偷他的車。If the car belongs to a female, it should be written as: 有人偷她的車。
6. In Chinese characters, this would be: 當然都知道。
7. 328 F.3d 593 (9th Cir. 2003).
8. The Ninth Circuit refers to Mr. Wang He as "Mr. He" and I follow their practice. However, in Chinese, the surname (what Americans often call the "last name") comes first, and "Wang" is a very common surname. Therefore, it seems probable that Mr. Wang He should be referred to as Mr. Wang rather than Mr. He.
9. *See*, *e.g.*, *Huang v. Advanced Battery Technologies*, 09-cv-8297(HB), 2010 U.S. Dist. LEXIS 51694, at *4-5 (S.D.N.Y. 26 May 2010) (discussing competing translations of a company's name; three different translations of a share transfer clause in an employment contract (including two contradictory translations submitted by the plaintiff); and two contradictory translations of the timing of a separate agreement (both submitted by the plaintiff)).
10. No. 09-0902 (LMM), 2009 U.S. Dist. LEXIS 50047 (S.D.N.Y. 20 May 2009).
11. *Id*. at *11-12.
12. *Id*. at *10-11.
13. *Id*. at *20-21.
14. *See Sook Ying Loo v. Prudential Ins. Co. of America*, No. 03-8409 (DLC), 2004 U.S. Dist. LEXIS 26001, *8 n.5 (S.D.N.Y. 30 Dec. 2004).
15. Sometimes one can express a past tense by adding words like "*le*" or "*guo*" after the verb, but these words do not correspond in a one-to-one manner to English tenses.
16. *See Tower Mfg. Corp. v. Shanghai ELE Mfg. Corp.*, 244 F.R.D. 125, 130-31 (D.R.I. 2007); *Cielo Creations, Inc. v. Gao Da Trading Co.*, 04-1952(BSJ), 2004 U.S. Dist. LEXIS 11924, *12-13 (S.D.N.Y. 28 June 2004).
17. *See Cielo Creations*, 2004 U.S. Dist. LEXIS 11924 at *12-13.
18. *See Tower Manufacturing*, note 16 *supra*, 244 F.R.D. at 133 (making this suggestion).

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# Cross-Border Private Mergers & Acquisitions

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## I. Introduction

In this article, we examine the key issues that a buyer in one country typically encounters when making a private acquisition of a business located in another country. These key issues are four-fold: (1) restriction on foreign investments in the country of the target; (2) merger control in the target's jurisdiction; (3) critical cross-border tax issues; and (4) other local traps for the unwary in the target's jurisdiction. We examine each of these issues in turn as applied to the following selected jurisdictions: Brazil; Canada; India; Panama; Sweden; and the United States.

## II. Restrictions on Foreign Investments

As will be seen in the discussion below, the countries examined have each adopted their own distinctive approaches to imposing restrictions on foreign investment. In the United States, the restrictions are directed at national security concerns. In Sweden, there are no restrictions on foreign investment, regardless of industry sector. The remaining countries in the survey seek to identify sensitive industry sectors. However, while there are some similarities in what these countries consider to be industries where foreign investment must be regulated, they are notable as much for their differences as for their areas of similarity.

### A. Brazil

The Brazilian foreign investment law, enacted in 1962, provides that no discrimination shall exist with respect to foreign capital and foreign investment in Brazil. However, the Brazilian Federal Constitution, enacted in 1988, establishes some restrictions on foreign investments and ultimately delegates to the federal laws the ability to regulate foreign investments, based on the national interest. The restrictions on foreign investment currently in place in Brazil generally relate to aviation, news media (including newspapers, radio and television), healthcare (including hospitals), and nuclear power.

Brazilian law currently limits foreign investment in domestic airline companies to a maximum of twenty percent of their voting capital, held directly or indirectly. In May 2009, Brazil's Civil Aviation Authority (*Agência Nacional de Aviação Civil*—ANAC) suggested an increase in the limit of foreign ownership in Brazilian airlines up to forty-nine percent of their voting stock. The proposal still awaits approval by the Brazilian Congress.

Similar restrictions apply to foreign investment in newspapers, magazines and other type of news publications, as well as in radio and television networks. In 2002, the Brazilian Congress amended the Federal Constitution to allow foreigners to hold thirty percent of the voting and total capital of companies in those businesses, while the remaining seventy percent must be held by Brazilian citizens (born in Brazil or naturalized not less than ten years ago). Prior to 2002, the news media sector was completely closed to foreign investments.

Other areas subject to an absolute restriction on the participation of foreign capital include nuclear energy and healthcare. The healthcare restriction is considered to be broad, including hospitals and health insurance, but there is reasonable room for debate about whether it extends to ancillary medical activities, such as diagnostic laboratories.

Foreign investment in the financial industry, although not restricted as to any percentage of equity ownership, is subject to an authorization process. The relevant Brazilian laws have been in force for the past two decades, and they provide that no financial, banking or credit institution may operate in Brazil without the prior approval of the President of Brazil. It does not appear that such authorization has been denied or overly delayed due to foreign ownership. In fact, a large number of major international banks operate subsidiaries and/or branches in Brazil.

Rural areas have recently become an area of concern with respect to foreign investment. Since 24 August 2010, a legal opinion of the Attorney-General (*Parecer da AGU*) ruled that certain provisions from a 1971 statute that previously had generally been considered incompatible with the 1988 Constitution were in fact in force. Such provisions make companies under foreign control subject to prior authorization as well as a number of limitations and formalities for the acquisition or lease of rural real estate in Brazil, under the penalty of the acquisition being considered null and void. Even where the purchaser is willing to apply for governmental authorization, more often than not the lack of accurate public records on land ownership will make it impossible to demonstrate that the acquisition is compliant with the applicable legal requirements, particularly in regard to the concentration of foreign ownership in the relevant municipality. As a result, the current scenario is one of significant uncertainty, and it is likely to remain so until a new law is passed on the subject. (Bills are in preparation.) Currently there is no strategy free of legal risk that would enable a foreign investor to acquire rural land in Brazil, and for approximately one year the market—which had been booming for a few years—has been inactive. In addition, Brazilian legislation imposes certain restrictions on the purchase by foreigners of real

estate located in border areas, which are considered essential to national security. The border area consists of a strip of land, one hundred fifty kilometers wide, which runs along the country's borders. Foreign individuals and legal entities may purchase real estate situated in essential (border) areas only after prior approval by the Brazilian national security authorities.

Due to governmental exchange controls, foreign direct investments in Brazilian companies must be registered with the Brazilian Central Bank as a condition for dividend distributions to nonresident investors, reinvestment of profits and repatriation of the investment. The registration is carried out through an online web-based system within thirty days after the date on which the investment flows into Brazil, and is a declaratory system (meaning that there is no judgment passed by the Brazilian Central Bank on the transactions being recorded, provided that they are legal and have economic grounds).

### B. Canada

The Investment Canada Act[1] requires that any non-Canadian that acquires control of a Canadian business (whether or not that business is controlled by a Canadian prior to the acquisition) must file either a notification or an application for review, unless, in either case, an exemption applies. For the purposes of this Act, a "non-Canadian" includes any entity that is not controlled or beneficially owned by Canadians.

If an investment meets the financial thresholds for review, an application for review must be filed and a determination made by a designated Minister of the federal government as to whether the transaction is of "net benefit to Canada." Any transaction that is not reviewable must be notified. Notification is made by completing a simple two-page form any time prior to or within thirty days after the closing.

In general, transactions are reviewable depending on the following four factors.

- Whether the investor is acquiring control of a Canadian business.
- Whether the investor is a "WTO Investor" (*i.e.*, controlled by persons from countries that are members of the World Trade Organization).
- Whether the target business is engaged in culturally sensitive activities (*e.g.*, broadcasting, film, video, audio, books, magazines).
- What is the asset-size of the target business.

In general, an investor acquires control of a Canadian business by acquiring at least a majority (i.e., more than fifty percent) of the voting shares of a company. The acquisition of less than a majority but not less than one-third of the voting shares of a company is presumed to be the acquisition of control of that company unless it can be established that, after the acquisition, the company is not controlled in fact by the acquirer through the ownership of voting shares.

The financial thresholds for a review are as follows. An indirect investment (*i.e.*, where the acquisition of the Canadian business occurs as a result of the acquisition of control of a corporation incorporated outside Canada) by a WTO Investor is subject to review only if: (i) the target Canadian business is cultural in nature and its assets are greater C$ Fifty Million or (ii) the value of the assets of the business located in Canada represents more than fifty percent of the total asset value of the transaction (*i.e.*, where the target is in substance a Canadian business). Indirect investments by non-WTO Investors are subject to review if the Canadian business has assets in excess of C$ Fifty Million. A direct investment (*i.e.*, the acquisition of the shares or assets of a Canadian company) by a WTO Investor is subject to review only if the target Canadian business (i) has assets valued at in excess of C$ Three Hundred Twelve Million in 2011 (a figure adjusted annually according to an inflation index) or (ii) is cultural in nature and has assets valued at greater than C$ Five Million. Direct investments by non-WTO Investors are subject to review if the Canadian business has assets valued in excess of C$ Five Million (irrespective of the target's industry sector).

A notification or application for review must be filed with the Department of Heritage (for cultural businesses) and the Investment Review Division of Industry Canada (in all other cases).

In addition to the Investment Canada Act, sector-specific reviews apply in areas such as broadcasting, transportation, banking and other financial services.

### C. India

#### (1) Automatic Route and Government Route

Non-residents can invest in an Indian company through two routes—the "Automatic Route" and the "Government Route."

The regulations under the Foreign Exchange Management Act, 1999 and the circulars issued by the Government relating to foreign direct investment ("FDI Scheme") prescribe, amongst other things, the sectors in which investments are limited, to a specified percentage of the share capital of the Indian company, and/or where prior approval is required for foreign investment (*i.e.*, the Government Route). Proposals for investments through the Government Route as set forth in the FDI Scheme from time to time are considered by the Foreign Investment Promotion Board in the Department of Economic Affairs, Ministry of Finance.

Under the Automatic Route, the investor or the Indian investee company does not need to obtain any prior approval from the Government of India or the Reserve Bank of India (India's central bank) for the investment.

#### (2) Sectoral Restrictions

Some of the sectors under the FDI Scheme in which foreign investment is not permitted under the Automatic Route, and requires specific approval, include broadcasting, single-brand retail, print and news media and defense.

The FDI Scheme also provides for sectoral caps which determine the extent to which investments can be made by non-residents in the share capital of a resident entity in certain sectors. In some cases, investments up to a particular limit are on the Automatic Route, and investments up to a specified higher limit are on the Government Route. Some of the important sectors in which caps on foreign investment are placed are: Banking (up to forty-nine percent on the Automatic Route, and thereafter up to seventy-four percent on the Government Route); telecommunications (up to forty-nine percent on the Automatic Route, and thereafter up to seventy-four percent on the Government Route); insurance (twenty-six percent); and aviation.

Further, in certain sectors such as non-banking financial services, and certain types of construction-development projects, entry conditions such as minimum capitalization, minimum lock-in periods, etc. must be met by non-resident investors.

#### (3) Prohibited Sectors

Foreign investment in some sectors such as retail trading (except single brand product retailing), lottery, gambling, betting, etc., trading in transferrable development rights, real estate business or construction of farm houses, manufacture of tobacco products, atomic energy and railway transport is completely prohibited. In businesses relating to lottery, gambling and betting activities, even licensing by non-residents for franchise, trademark, brand-name or the entry into management contracts is completely prohibited.

#### (4) Pricing Restrictions

The FDI Scheme imposes a minimum valuation at which a non-resident can make investments in India, as well as a maximum valuation at which a non-resident can sell its shares to an Indian resident or to the issuing company (*i.e.,* a buy-back by the issuing company). In the case of listed companies, the minimum and maximum valuations are based on the market price of the shares. In the case of unlisted companies, the minimum and maximum valuations are based on valuations to be prepared by reference to the value determined in accordance with the discounted free cash flow ("DCF") method of valuation. Effectively, this imposes a "floor" price at which a non-resident can make an investment in India, and a "cap" or "ceiling" price, above which a non-resident cannot exit its investment, if the sale is being made to an Indian resident or if there is a buy-back of shares by the Indian issuer.

### D. Panama

In Panama, there are no restrictions on foreign investments, except for aviation, radio and television and for companies engaged in retail trade.

### E. Sweden

There are no restrictions on foreign investments in Sweden, but there is a residency requirement for the board of directors to the effect that at least half of the directors must reside within the European Economic Area.

### F. United States

In 1988, Congress enacted "Exon-Florio," which was an amendment to Section 721 of the Defense Production Act of 1950,[2] giving the President of the United States the authority to review all mergers, acquisitions and takeovers that could result in foreign control of a U.S. business and suspend, block or order divestiture of any such transaction if it may threaten to impair national security. Only the President can block a transaction. The Committee on Foreign Investment in the U.S. ("CFIUS"), which administers Exon-Florio, can enter into "mitigation agreements," which are remedial agreements short of a full-stop against the transaction. Exon-Florio was recently amended by the Foreign Investment and National Security Act ("FINSA"). The FINSA amendments do not materially change the substance of the Act, but they do impact process.

CFIUS has nine official members: Secretary of the Treasury; Secretary of Homeland Security; Secretary of Commerce; Secretary of Defense; Secretary of State; Attorney General of the U.S.; Secretary of Energy; the Office of the U.S. Trade Representative; and the Office of Science and Technology Policy. There are also several other participating members and *ex officio* consultants, when necessary.

Notification under FINSA is voluntary. However, the failure to notify transactions that are covered by FINSA and impact national security can entail serious risks. Importantly, non-notified transactions are forever subject to review by CFIUS, mitigation and possible divestiture.

Notification hinges upon whether the transaction is a "covered transaction." FINSA defines "covered transaction" to be "any merger, acquisition, or takeover...by or with any foreign person which could result in foreign control of any person engaged in interstate commerce in the United States." This is the fundamental threshold question because if the transaction does not fall within the meaning of "covered transaction," then notification is not

required regardless of whether the transaction may have a national security impact. The concept of "control" under FINSA is very broad and the definition encompasses direct and indirect control and influence. Various factors that can constitute control are set forth in the implementing regulations.[3] Minority investments can constitute control if the investor has the right to, among other things, appoint directors and take action on other important business matters. However, there is an exemption for investments of up to ten percent of the voting interests if the investor intends to remain passive. The exemption for passive investments is similar to the exemption from filing a notification and report form under the Hart-Scott-Rodino Act.[4] There are various other exemptions and exclusions that could apply, and parties should communicate with their counsel about the applicability of any such exemptions or exclusions.

If it is determined that a transaction is a "covered transaction"—a foreign person could acquire control over a U.S. business through the transaction—then the next step in the analysis is to determine whether the transaction may impair U.S. national security. This part of the analysis is complicated by the fact that "national security" is not defined in the statute or the regulations, although the Treasury Department has disseminated guidance to assist parties in making the assessment. In addition, the statute itself provides a list of factors to consider, including, but not limited to:

- effects on the commercial activity, capability and capacity of domestic industries to meet national defense or national security requirements, including the availability of human resources, products, technology, materials, and other supplies and services;
- effects on U.S. critical technologies;
- effects on the long term requirements for sources of energy and other critical resources and material; and
- effects on critical infrastructure, including major energy assets.

Most transaction that are notified under Exon-Florio are cleared after a thirty-day review period. Under Exon-Florio, CFIUS has thirty days to review a complete filing. Pre-filing consultations between the parties and CFIUS are encouraged because, among other things, the thirty-day clock does not begin to run until CFIUS deems the parties' filing complete. CFIUS may, and in certain limited circumstances, must, initiate a formal forty-five-day investigation of the transaction. One such circumstance is when the buyer is a foreign government or is controlled by or acting on behalf of a foreign government. Another such circumstance is when the transaction involves the acquisition of "critical infrastructure" and CFIUS believes an investigation is warranted.

CFIUS may further recommend that certain transactions be referred to the President to determine whether to block the transaction. The President has fifteen days to determine whether to do so. Throughout the entire process, the parties may stop and restart the clock—pull and refile their notification—in order to respond to questions and make arguments to CFIUS where appropriate.

As previously mentioned, non-notified transactions remain forever subject to review and potentially to divestiture, unwinding or mitigation. In contrast, transactions that have been notified under Exon-Florio have a safe harbor if CFIUS advises the parties in writing that a transaction is either not a covered transaction or that CFIUS has concluded all action and does not intend to take action, or the President has previously announced an intention not to take action.

Only one transaction has been blocked under Exon-Florio. However, mitigation agreements to remedy problems are common.

In addition, there are federal and state laws regulating the foreign ownership of television and radio stations and communications satellites, commercial fishing in U.S. waters, as well as foreign ownership of agricultural lands, mining claims and mineral rights on public lands, and operations in air transport and nuclear fuel facilities. Moreover, there are various "Buy American" laws and regulations which require some governmental entities to buy only from U.S.-owned businesses. Finally, certain security clearances may be required to do business in certain sensitive projects for the federal government or the military.

## III. Merger Control

All jurisdictions have a substantive merger control regime. As well, apart from Panama, which does not have a mandatory process, all jurisdictions have a pre-merger notification process of some description. The regimes applicable in the European Union and Canada bear the closest resemblance to the U.S. merger control regime, including the pre-merger notification requirements of the Hart-Scott-Rodino Antitrust Improvements Act of 1976 ("HSR Act").

### A. Brazil

Brazil's Competition Law[5] requires the notification of any mergers and acquisitions that may limit free competition, or which result in the control of significant markets for products or services in Brazil, based on the following criteria:

(1) one of the parties to the transaction or their respective economic groups have recorded, in their last fiscal year, gross revenues in Brazil of at least R$400 million or its equivalent in other currencies; or

(2) the entity or group of companies resulting from the transaction holds at least twenty percent of a relevant market in Brazil.

All transactions which meet one of such legal criteria shall be submitted to the Brazilian antitrust authorities within fifteen business days from the date the first binding document was executed by the parties. The failure to notify a transaction or a delay may subject the parties to fines.

### B. Canada

The Competition Act[6] is the statute of general application to all mergers in Canada. Subject to certain industry-specific statutes that preempt the Act (such as banking), the Act has substantive application to all mergers (including asset and share acquisitions and amalgamations) with a Canadian nexus irrespective of notifiability.

There are two distinct issues under the Competition Act. First, is a pre-merger notification filing required? Second, will the transaction result (or is it likely to result) in a substantial lessening or prevention of competition in any relevant market? If a pre-merger notification is required, the transaction will likely be reviewed by the Commissioner of Competition (the "Commissioner") to determine whether it will or is likely to result in a substantial lessening or prevention of competition. The procedural and substantive provisions of the Act apply independently of each other. That is, even if the transaction does not raise substantive competition issues, it may still be subject to pre-merger notification if certain financial thresholds are exceeded. Conversely, even if the transaction is not subject to a pre-merger notification requirement, it may still be reviewed under the substantive merger provisions of the Act.

The pre-merger notification regime is a function of party-size, transaction-size and extent of ownership. The pre-merger notification requirement is triggered where the acquirer (and its affiliates):

(1) passes the threshold of thirty-five percent ownership in the case of shares in a private company operating a business in Canada (twenty percent in the case of shares in a publicly traded company); or

(2) passes the threshold of fifty percent ownership where the acquirer already holds thirty-five percent of such shares.

A pre-merger notification is not required unless both party-size and transaction-size thresholds are met. The party-size threshold is more than C$400 million in assets in Canada or sales in, from or to Canada (*i.e.,* domestic sales, exports and imports) in the most recently completed financial year, taking into account the parties to the transactions and their worldwide affiliates. For 2011, the transaction-size threshold is more than C$73 million of acquired assets in Canada or more than C$73 million in revenues generated by those assets. The transaction-size threshold is adjusted annually according to an inflation index.

After a pre-merger notification is filed, there is an initial thirty-day waiting period during which the parties cannot close the transaction. The thirty-day waiting period, which may be abridged, runs from when a complete filing is certified. However, this thirty-day no-close period can be extended, including as a result of a supplementary information request from the Commissioner. Time periods for completing a merger review vary greatly depending on complexity—from as little as two weeks in the case of non-complex mergers to as much as five months for very complex mergers.

### C. India

Acquisitions, mergers or amalgamations that meet the thresholds prescribed under the Competition Act require mandatory pre-notification and approval from the Competition Commission of India. The transactions that are generally exempt from the above pre-notification requirement, despite the trigger of the thresholds, include the following.

- Acquisitions where the target enterprise either has assets of less than Rs 2.5 billion in India or turnover of less than Rs 7.5 billion in India.
- Acquisitions of shares or voting rights made solely as an investment or in the ordinary course of business, provided that the total shares or voting rights held by the acquirer directly or indirectly do not exceed fifteen percent of the total shares or voting rights of the target enterprise, and there is no acquisition of control of the target enterprise.
- Acquisitions of shares or voting rights by an acquirer who has fifty percent or more of the shares or voting rights of the enterprise prior to the acquisition, except where the transaction results in a transfer from joint to sole control.
- Acquisitions of assets not directly related to the business activity of the party acquiring the assets or made solely as an investment or in the ordinary course of business, not leading to control of an enterprise, and not resulting in acquisition of substantial business operations in a particular location or for a particular product or service.

### D. Panama

In Panama, there is no mandatory merger control approval process. The process is entirely voluntary. Nevertheless, with the new antitrust and competition regime established by Law 45 of 2007 ("Competition Law"),

economic concentrations created by mergers within the Panamanian market have come under increasing scrutiny. The Competition Law does not prohibit all economic concentrations but only those whose effects may unreasonably restrict or harm competition. In addition, the Competition Law expressly provides that the following business combinations shall not be deemed prohibited economic concentrations:

- Joint ventures formed for a definite period of time to carry out a particular project.
- Economic concentrations among competitors that do not have harmful effects on competition and the market.
- Economic concentrations involving an economic agent that is insolvent, if certain conditions are met.

### E. Sweden

The Swedish Competition Act will apply if the parties are involved in a concentration which will have an effect on the Swedish market. There is no exception for foreign-to-foreign mergers. A concentration will arise if:

- two or more previously independent companies merge;
- one company, directly or indirectly, obtains control over another company, by way of acquisition, by agreement or by any other means; or
- a joint venture performing all the functions of an autonomous economic entity is created on a lasting basis ("full-function joint venture").

When the following thresholds are met, a concentration is subject to mandatory notification to the Swedish Competition Authority:

- the combined aggregate annual turnover in Sweden of the undertakings concerned exceeds SEK 1 billion in the preceding financial year; and
- each of at least two of the undertakings concerned have a turnover in Sweden exceeding SEK 200 million in the preceding financial year.

The whole group of each undertaking is included in the calculation of turnover. A notification must be made prior to the completion of the concentration. Upon receipt of a complete notification, the Competition Authority has twenty-five working days to issue a decision either approving the concentration or initiating a special (in-depth) investigation. During this twenty-five-day period the parties must not take any action to complete the concentration (the "stand still" period). If the Competition Authority receives commitments from the parties, the period will be automatically extended to thirty-five working days.

If there is a decision to initiate a special investigation, the Competition Authority has an additional three months to review the concentration, but this period may be extended. At the end of the three-month period, the Competition Authority must decide either to approve the concentration or to apply to the Stockholm District Court for a prohibition. A concentration may be prohibited if it would significantly impede effective competition, in particular as a result of the creation or strengthening of a dominant position or if a prohibition would interfere with important national interests of security and supply of resources. If a concentration is prohibited, it becomes void. A third party cannot appeal against a decision to approve a concentration.

Also, the competition law regime of the European Union ("EU") must be taken into account. EU merger control covers large-scale transactions with effect within the EU/EEA area.[7] EU merger control rules also apply within the EEA area. Again, there is no exception for foreign-to-foreign mergers. EU merger control is based on the principle "one-stop-shopping"—meaning that, if the thresholds are met, the national competition authorities of the member states are precluded from reviewing the merger. Below the thresholds, the national competition authorities in the member states may review the merger.

Concentrations are subject to mandatory notification to the European Commission ("EC") in accordance with Council Regulation number 139/2004 (the "ECMR") if the below thresholds are met:

- the aggregate world-wide turnover of all the undertakings concerned, *i.e.*, typically the purchaser (including the group of companies to which it belongs), and the target (including the group of companies that it controls), exceeds €5 billion; and
- the EU-wide turnover of each of at least two undertakings concerned exceeds €250 million.

However, the ECMR does not apply if a merger has its primary impact within a single member state. This is deemed to be the case when more than two-thirds of the EU turnover of each of the parties involved in the merger is in one and the same member state ("two-thirds rule"). In addition, the ECMR is applicable to smaller concentrations with effect within at least three member states, if all of the following thresholds are met:

- the aggregated world-wide turnover of all the undertakings concerned exceeds €2.5 billion;
- the EU-wide turnover of each of at least two undertakings concerned exceeds €100 million;
- the aggregated turnover of all the undertakings concerned exceeds €100 million in each of at least three member states; and

– in each of those three member states, at least two undertakings concerned each had a turnover exceeding €25 million, unless the two-thirds rule is applicable (see above).

If the above thresholds are met, notification to the European Commission is mandatory and must be made before completing the concentration. Notification can be made using a Form CO or, if a concentration is unlikely to raise competition concerns, through a short Form CO (simplified procedure). Within twenty-five working days after receiving a formal notification, the Commission has to decide whether the ECMR applies ("Phase I") and, if so, whether to approve the merger or to open formal proceedings ("Phase II"). The Commission has the power to prohibit a merger if it would significantly impede effective competition in the common market or in a substantial part of it.

### F. United States

The HSR Act is a procedural statute that requires parties to certain specified transactions to notify and submit prescribed information to the Federal Trade Commission ("FTC") and the U.S. Department of Justice ("DOJ") prior to consummation of the transaction. Both acquiring and acquired entities must file premerger notification forms.

Unless a statutory exemption applies, currently notification under the HSR Act is required for acquisitions of voting securities or assets valued in excess of USD $66.0 million. For acquisitions of voting securities or assets that do not exceed USD $263.8 million, a "size-of-person" test also applies. The size-of-person threshold is satisfied if one party has total assets or annual net sales of USD $131.9 million and the other party has total assets or annual net sales of USD $13.2 million or more. These size-of-transaction and size-of-person thresholds are adjusted annually to reflect inflation.

The HSR Act requires parties to observe an initial waiting period prior to consummating the transaction, unless terminated early or extended by the issuance of a request for additional information and documentary material, known as a "Second Request." For most transactions, the initial waiting period is thirty days; for transactions involving all-cash tender offers or targets in U.S. bankruptcy protection, a shorter fifteen-day waiting period applies. The U.S. antitrust agencies may determine to issue a Second Request if there is concern that the transaction may present potential harm to competition. Upon issuance of a Second Request, the waiting period is suspended for an additional thirty days (or in the case of a cash tender offer or bankrupt target, ten days) after compliance with the request. Compliance can be burdensome and take several months.

Exemptions may apply to acquisitions of non-U.S. assets or securities. Acquisitions of foreign assets are exempt unless the assets generated more than USD $66.0 million. Acquisitions of voting securities of a foreign issuer are exempt unless the issuer has U.S. assets of over USD $66.0 million or sales in or into the U.S. of more than USD $66.0 million. If the acquirer is also foreign, the acquisition is exempt unless it confers control of the foreign issuer. Even if the above criteria are met, acquisitions of foreign assets or securities by foreign buyers are exempt if the transaction is valued at USD $263.8 million or less, and both the buyer and target have U.S. assets and sales in or into the U.S. of less than USD $145.1 million. These thresholds are also adjusted annually for inflation.

## IV. Critical Tax Issues

The tax rules applicable to mergers and acquisitions transactions are complex and require specialist tax advice in each jurisdiction. Each jurisdiction accords different treatment depending, among other things, on whether it is a purchase of shares or assets and whether the consideration for the purchase consists of cash or stock in the buyer. In the space available, it is only possible to outline the applicable tax regimes in each jurisdiction in the highest level of generality. Detailed discussion is beyond the scope of this article.

### A. Brazil

Generally, mergers and acquisitions may be accomplished tax free in Brazil, as long as assets are transferred at book value and other formalities are met. However, the sale of equity interests in Brazilian companies at a premium may be taxable—at the rate of fifteen percent of the capital gain realized by the seller—even when buyer and seller are outside of the country.

There is no stamp tax in Brazil. However, the inflow and outflow of funds involving foreign investors is generally subject to tax on financial transactions—foreign exchange ("IOF Câmbio") at the rate of 0.38%. Hence, any merger and acquisition involving a local and a foreign counterparty will be subject to this tax over the purchase price, regardless of who is the buyer or seller. On the other hand, if both parties are either outside or inside Brazil, no such tax will be levied upon the purchase price.

In addition, since October 2009 the inflow of foreign funds into the Brazilian financial and capital markets became subject to a tax on financial transactions ("IOF Crédito") at a rate of two percent. Therefore, stock acquisitions of Brazilian listed companies made by foreign investors through the stock exchange are subject to this tax.

Finally, foreign loans granted to Brazilian borrowers for a term of less than two years also became subject to this tax (IOF Crédito), but at an increased rate of six percent. However, if granted with a maturity of more than two years, the tax rate is reduced to zero.

Recent changes in Brazilian law, brought into effect as of 16 December 2009, introduced thin-capitalization rules. The rules set forth requirements for the deductibility of

interest expenses arising from foreign loans. In summary, for tax purposes, a Brazilian subsidiary's interest expense will not be a deductible expense if the respective debt is higher than:

– two times the amount of the equity ownership held by the foreign lender (for foreign lenders not located in tax havens); or

– thirty percent of the net equity of the borrower (for lenders located in tax havens—being a related party or not).

Such rules also apply when the foreign related party, although not being the creditor, acts as guarantor, surety, representative or intervening party in the debt. These new rules also provide for other requirements to allow the deductibility of interest payments to beneficiaries located in tax havens, such as the identification of the effective beneficiary of the income (being the entity or person not created for the purpose of avoiding taxes).

Foreign investors usually acquire Brazilian target companies through Brazilian investment vehicles. Such an acquisition strategy enables the foreign buyer to benefit from the deductibility, for corporate income tax purposes, of any premium that is paid. If the purchase price exceeds the book value of the target company, the difference is treated as a premium. Therefore, a Brazilian purchaser must segregate the purchase price into two items: (i) net worth of the acquired company; and (ii) premium paid upon the acquisition. The Brazilian Income Tax Law, in certain circumstances, authorizes the premium to be amortized for tax purposes, should the legal entity which purchased the operating company be merged into such an operating company. If the premium is economically attributed to the expectation of future profitability, it may be booked as a deferred asset after the merger and amortized at a rate no faster than sixty months, *i.e.*, not more than twenty percent per annum.

### B. Canada

In general, sellers of Canadian-controlled private companies prefer to sell shares rather than assets because (i) each individual Canadian vendor is entitled to a C$750,000 lifetime capital gains exemption on the sale of shares in a qualified small business corporation and (ii) to the extent not exempt, generally only fifty percent of any capital gains arising from the sale are taxable in the hands of the seller. Hence, there are often tax efficiencies to the parties in buying and selling shares in Canadian private companies.

When structuring a Canadian acquisition, all buyers must be mindful that, unless exempted by an applicable tax treaty, sellers who are non-residents of Canada are generally liable for Canadian income tax on the disposition of "taxable Canadian property" (as defined under the Income Tax Act (Canada)).[8] Taxable Canadian property includes, *inter alia* (i) real property located in Canada, (ii) Canadian resource and timber properties and (iii) shares in a Canadian company where more than 50% of their value derives from Canadian real properties or resource or timber properties. Buyers must either (i) obtain satisfactory evidence that the seller is not a non-resident of Canada or (ii) remit a portion of the consideration to Canada Revenue Agency unless, on or before closing, the seller provides a certificate of compliance from the Agency with a certificate limit that is for an amount not less than the proceeds of disposition.

A foreign buyer must particularly bear in mind the following four tax-related issues. First, if the foreign buyer wishes to have a Canadian flow-through tax entity as a component of the acquisition structure, Canada does not have the concept of a "limited liability company" (or LLC). Instead, the choices for Canadian flow-through entities are a partnership (typically, a limited partnership) or an unlimited liability company (or ULC). Second, when acquiring shares in a Canadian target, the foreign buyer will generally wish to utilize a Canadian corporate acquisition vehicle so that the full purchase price can be repatriated to the foreign jurisdiction free of Canadian withholding taxes. Third, a foreign buyer must be mindful of ensuring that the Canadian target complies with the thin-capitalization rules, which require a debt-equity ratio of in respect of related party non-resident debt of not more than 2:1. Otherwise, a portion of the subject interest expense will be disallowed in computing the income of the Canadian target. Fourth, the foreign buyer will wish to minimize the rate of Canadian withholding tax applicable on dividends received from its Canadian subsidiary. The rate under the Act is twenty-five percent, subject to reduction by virtue of an applicable treaty. In the case of a U.S. investor eligible for benefits under the Canada-U.S. Tax Convention, the applicable withholding rate is reduced to five percent (in the case of a corporate dividend recipient owning not less than ten percent of the voting shares in the dividend payer) and fifteen percent in all other cases.

### C. India

Under the Indian tax regime, tax is levied, amongst other things, on capital gains arising out of a transfer of capital assets, under Section 45 of the Indian Income Tax Act. A recent judgment in the *Vodafone* case[9] states that, if there is a transfer of shares of a foreign company which has substantial assets in India, then even such transfer would have tax incidence in India. This judgment has a far reaching effect on mergers and acquisitions transactions, and as such has had a negative impact on the Indian investment climate.

Further, large amounts of money have come into India through Mauritius, which is a tax efficient jurisdiction. However, the fact that the India-Mauritius Tax Treaty is constantly under attack from the Indian Revenue Department further dampens the investment climate.

## D. Panama

The tax treatment of a merger depends on whether the merger is a stock-for-cash or a stock-for-stock transaction.

Stock purchases are subject to a ten-percent capital gains tax on Panama source gains in the same manner that stock-for-cash transactions is taxed, including the five-percent advance withholding tax. If the purchase is structured as a cash transaction, it will be considered as a gain on the difference between the cash received and the cost of the stock sold. On the other hand, if the transaction is structured as an in-kind transaction, to ascertain the gain, the value of the stock or assets received as consideration would be determined either at their fair market value at the time of the transfer or at book value if their market value cannot be fairly assessed.

Stock-for-cash mergers are also taxable transactions in Panama. The law requires buyers to withhold a ten-percent capital gains tax on Panama source gains in the same manner that stock-for-cash is taxed, including the five-percent advance withholding tax. On the other hand, stock-for-stock mergers are fully tax-free, provided that certain accounting conditions are followed. Shareholders of the target company who receive shares of the surviving company have a tax basis on the new shares equal to their average pre-merger tax basis on the surrendered shares.

Asset buy-outs normally are considered as taxable transactions. Gains resulting from the sale or disposition of an asset are subject to a ten-percent capital gains tax. The only exception to the latter is the sale or disposition of real estate, which is subject to a special tax treatment. The transfer of tangible personal assets, such as inventory and equipment, is also subject to a seven-percent value added tax based on the book value of the asset at the time of the transfer. Real estate purchases or transfers are subject to a two-percent transfer tax. Parties interested in acquiring assets or ongoing businesses must be aware that they will be jointly and severally liable for the tax obligations of sellers on the purchased assets or business.

Mergers and acquisitions transactions frequently involve either a pre-closing or a post-closing dividend. Corporations are subject to a ten-percent dividend tax (twenty percent if the shares are issued to bearer) on Panama source income.

## E. Sweden

The Swedish corporate tax system has several interesting features that can be used to reduce the tax burden. The absence of thin capitalization rules allows the use of highly leveraged structures. A Swedish limited liability company ("LLC") may be financed by equity through shareholders' contributions and/or by loans from a foreign group company or from a foreign bank which is resident in a low-tax jurisdiction. This results in advantageous taxation of the interest income on the loan. Provided that the interest rate is consistent with market rate, interest paid will normally be fully tax-deductible for the Swedish LLC (although special rules apply if the foreign recipient is taxed at a rate of less than ten percent on the interest income). No withholding tax is levied on the interest payments made to the foreign lender. The capital can be used by the Swedish LLC to make investments in Swedish and foreign subsidiaries. The Swedish tax regime allows for a combination of no thin capitalization rules and no capital duty, often together with full tax-deductibility of interest expenses. It is also possible to combine group contributions paid to domestic companies with full tax-deductibility of interest payments made to foreign recipients to minimize income and thus reduce corporate taxation, provided that certain requirements are met.

There are extensive exemptions from the general Swedish withholding tax ("WHT") of thirty percent levied on dividends paid to non-residents. For legal entities residing within the EU/EEA, normally no WHT is levied if the shareholder holds at least 10% or more of the capital in the distributing company. In addition, no WHT is levied on dividends paid by a Swedish company to a foreign company on business-related shares. The last exemption is not applicable to dividends on shares held as inventory (current assets), since these shares do not qualify as business-related shares.

## F. United States

Corporate mergers and acquisitions in the U.S. may often be structured as tax-free reorganizations, provided a sufficient portion of the consideration paid to shareholders of the target is in the form of stock of the acquirer and certain other requirements are met. The corporate form of the transaction will determine in part which additional requirements must be satisfied to achieve tax-free reorganization treatment. A tax-free reorganization will generally result in the non-recognition of gain by the target and the shareholders of the target, and the acquirer will take a carryover basis in the stock and/or assets of the target.

Transactions involving the acquisition of a U.S. target by a foreign acquirer will be subject to additional requirements to achieve tax-free treatment. Specifically, the foreign acquirer is required to have been engaged in the active conduct of a trade or business for a three-year period, the acquirer stock received by U.S. target shareholders in exchange for their target stock can represent no more than fifty percent of the total voting power and total value of the foreign acquirer, and the fair market value of the foreign acquirer must be at least equal to the fair market value of the U.S. target, among other requirements.

If a stock acquisition cannot qualify as a tax-free reorganization (for example, because the mix of consideration includes too much cash, or because other requirements

cannot be satisfied), the selling shareholders of the U.S. target will generally recognize gain or loss with respect to their stock.

A taxable asset acquisition will generally result in a cost basis in the acquired assets to the acquirer, with the possibility of additional depreciation and amortization deductions in the event of a step up in the basis of the assets. Intangible assets are generally amortizable over a fifteen-year period. A foreign acquirer of U.S. assets should consider whether to acquire the assets directly (and operate the acquired business as a branch) or instead acquire the assets through a U.S. subsidiary. A foreign corporation directly engaged in the conduct of a trade or business in the U.S. will be subject to U.S. tax on business income which is effectively connected with the conduct of such trade or business on the same basis as if the foreign corporation were a domestic corporation. In addition, such U.S. branch will be subject to a thirty-percent branch profits tax on any amounts distributed to the foreign parent. The branch profits tax may be reduced under applicable treaties. If instead the foreign acquirer acquires the U.S. assets through a U.S. subsidiary, such subsidiary will be subject to net basis corporate income tax on its income, just as any other domestic corporation.

In the case of a taxable stock purchase where the target is a member of a U.S. consolidated group (or if the target has significant net operating losses), the parties may want to consider making an election under Section 338(h)(10) of the Internal Revenue Code. The election allows the stock purchase to be treated as an asset purchase for tax purposes, resulting in a cost basis in the assets of the U.S. target to the acquirer.

Where a target corporation has tax attributes, including net operating losses, from prior years that may be carried forward, acquirers should consider the application of the Section 382 limitation on the use of such tax attributes. Section 382 will generally apply where there is a greater than fifty-percent shift in ownership of the stock of a corporation over a three-year period, and in such cases will limit the use of pre-acquisition net operating losses in the period following the acquisition. The application of the Section 382 limitation can reduce the value of such losses and should be taken into account to the extent value is being attributed to those losses as part of the transaction.

Foreign acquirers should be familiar with the U.S. tax consequences of owning stock in a U.S. corporation. Generally, dividends and interest paid by a wholly owned U.S. subsidiary of a foreign corporation will be subject to a thirty-percent withholding tax. However, the rate of withholding is often reduced or eliminated under applicable treaties.

The sale by a foreign person of stock of a U.S. corporation will generally give rise to capital gains (or losses) that are sourced in the jurisdiction of the seller. Therefore, such gains will not be subject to tax in the U.S. (except to the extent the gain is effectively connected with a trade or business conducted by the foreign seller in the U.S.). The principal exception is with respect to U.S. real property. The sale by a foreign person of an interest in U.S. real property (or a U.S. real property holding corporation) is subject to a ten-percent withholding tax on the gross purchase price.

## V. Other Local Traps for the Unwary

By its nature, the topic of local traps for the unwary foreign buyer or investor entails an element of surprise and defies commonality.

### A. Brazil

Among the issues that foreign parties should understand when making an acquisition in Brazil are the treatment of non-compete clauses, statutes of limitations of some specific liabilities and the choice of arbitration versus litigation in court.

The Brazilian Administrative Council for Economic Defense ("CADE"), the antitrust authority in Brazil, has a particular standard for non-compete clauses. According to CADE, a non-compete clause should be limited to a five-year term and to the geographic market in which the parties really act or to the place where the transaction might produce its effects.

With respect to statutes of limitations, severance fund liabilities ("FGTS") and environmental liabilities have a very peculiar legal treatment. Severance fund liabilities in Brazil are subject to a statute of limitation of thirty years. Environmental liabilities have no statute of limitations and, therefore, due diligence becomes even more important, especially considering that such liability may arise at the administrative, civil and criminal levels, each level being independent and possibly cumulative. Successors are likely to be held liable for environmental liabilities caused by predecessors in the administrative and civil spheres, but less likely to be liable for environmental crimes caused by predecessors (provided that successors take the necessary steps to cease the conduct that is considered to be a crime immediately after closing).

With respect to dispute resolution, the Brazilian court system is considered inefficient, being significantly slow (mostly due to understaffing and a bureaucratic appeal system) and unprepared to deal with corporate law matters (the number of courts specialized in corporate matters is insignificant and have a very limited geographic reach). In light of that, arbitration is generally seen as a more efficient means of dispute resolution in Brazil. Since the enactment of the Brazilian Arbitration Law in 1996, several different arbitration entities have developed over the years and have been performing well. Moreover, Brazil has adopted the 1958 United Nations Convention

on the Recognition and Enforcement of Foreign Arbitral Awards (the "New York Convention"). Notwithstanding the Convention, it is highly advisable to hold the arbitration proceedings within Brazil (even where the governing law is foreign and the language is not Portuguese), since the Brazilian Arbitration Law requires foreign arbitral awards to be submitted to the Brazilian Superior Court of Justice for confirmation of its formal requirements (although there is no reexamination of the merits, this proceeding takes a reasonable amount of time).

### B. Canada

Among the important issues for foreign parties to consider in a Canadian transaction are liability to employees of the target, environmental liabilities, bulk sales and the registration requirement for purchases of book debts.

If the target business has Canadian employees, an analysis should be made of the potential severance obligations should any of the employees be terminated by the buyer post-closing. Canada does not have an employment-at-will concept. Employees are protected from dismissal by both employment standards legislation (mandating minimum severance and termination pay obligations which cannot be altered by contract) and common law protections requiring reasonable notice of termination or pay in lieu of notice (which are subject to contract). As well, buyers of assets are subject to certain successor employer responsibilities, including those arising under collective bargaining agreements.

If the target business owns or leases real property, the buyer will need to consider its exposure to environmental liability—both for existing/historic soil or water remediation claims and ongoing environmental contamination. In Ontario, environmental liability claims are not subject to an ultimate limitation period.

In Ontario, buyers of assets can become liable to the seller's unpaid creditors under bulk sales legislation. However, if time permits, such liability exposure can be eliminated by obtaining a judicial exemption or by other means.

A buyer of the accounts (including accounts receivable) or chattel paper (such as leases of vehicles or equipment) of a business must register a financing statement under applicable personal property security legislation (modeled on Article 9 of the Uniform Commercial Code in the U.S.) even if the transfer is absolute and does not create a security interest. Failure to do so will result in the subordination of the buyer's interest to the interests of subsequently registered transferees.

### C. India

Issues of particular importance to foreign parties completing a merger and acquisition transaction in India include the enforceability of restrictive covenants, weak judicial and arbitral enforcement regimes, low levels of regulatory compliance in many industries and inadequate anti-corruption policies.

Foreign companies conducting business in India often seek to include confidentiality, non-compete and non-solicitation covenants in their agreements, including with Indian joint venture partners, sellers of Indian businesses, senior management and employees, as is customarily done in certain foreign jurisdictions. Some of these covenants are also expressed to apply after the term of the contract. However, Indian courts have (except in the case of one statutory exemption) consistently refused to enforce post-termination, non-compete clauses in contracts, viewing them as a "restraint of trade" impermissible under Section 27 of the Indian Contract Act, 1872, and as void and against public policy because of their potential to deprive an individual of his or her fundamental right to earn a livelihood.

Delay in judicial pronouncements means in effect that there is a weak judicial enforcement mechanism. Therefore, a prudent investor needs to factor this issue into the price and needs to negotiate certain matters as conditions precedent, rather than relying on representations and warranties. This also necessitates a proper background check on the opposite parties and generally treading cautiously prior to the consummation of the deal.

Litigation in India tends to be very prolonged and enforcement of an arbitral award is also subject to challenge at the time of enforcement. The Arbitration and Conciliation Act, 1996 contains provisions for challenging an arbitral award in courts in certain situations. The manner in which these provisions have been interpreted has produced a result almost akin to an appeal from the arbitral award.

Owing to low levels of compliance in certain industries, it is common to find companies in violation of multiple regulations. This state of affairs exposes investors to unexpected liabilities such as financial liabilities of the investee company, which indirectly impact investments, or liabilities on the directors nominated by the investors.

Further, inadequate policies to restrict bribery or other forms of corruption may also place foreign investors in a vulnerable position, particularly with respect to anti-corruption legislative requirements imposed on them in their home jurisdictions.

### D. Panama

Panama has a civil legal system. That is, the parties contractually address the main obligations, and Panamanian law fills in the gaps on other issues. This results in transaction agreements typically running to only five to ten pages. As the Panamanian economy began attracting

foreign investment, mergers and acquisitions have seen much more influence by common-law concepts. Now, in deals regarding a Panamanian target company, parties will encounter preliminary agreements such as letters of intent or memoranda of understanding, as well as confidentiality/non-disclosure and/or exclusivity agreements. These preliminary agreements are typically followed by a due diligence process dealing with both the legal, operational, financial and technical aspects of the target.

The main transaction agreement—whether a stock purchase agreement, asset purchase agreement or merger agreement—will address all relevant aspects of the transaction in detail. It will contain exhaustive representations and warranties, detailed conditions precedent, mechanisms for purchase price adjustments, escrows, remedies for breach, non-competition, termination, confidentiality, and so on.

### E. Sweden

Some of the chief concerns for a foreign party wishing to conduct a merger or acquisition in Sweden concern consultation with unions representing the affected workers, post-termination restrictive covenants, environmental liability and the inability to obtain representations from the target company.

The attitude towards foreign investments is very open in Sweden, and Swedish businesses are used to an international environment and "international style documents." Nevertheless, Swedish agreements are traditionally briefer than Anglo-American documents and there is much to gain by presenting a document which has been adapted to the Swedish tradition without having to compromise on the actual scope and coverage of the documents.

At most larger workplaces, the unions play a role and must be taken into account. The unions in Sweden are mostly not militant or an obstacle in pursuing a transaction and any subsequent reorganization. They are rather business-minded and co-operative as long as they are kept informed, and are consulted with, as they are entitled to under mandatory laws. If an agreement is reached with the union, a reorganization may be much smoother. It is the employer who eventually has the right to decide, and the employer does not need to await the union's consent once the union has been duly informed and consulted with.

Generally, in an asset transfer resulting in a transfer of employees in Europe, the employees are entitled to be asked whether they wish to transfer with the business or remain employed by the seller. In Sweden, an employee would typically consent to be transferred because the seller may otherwise terminate the employment due to redundancy. Upon redundancy, the employee is normally only entitled to salary during the notice period but not to any other severance payment, unless provided for in the employment agreement or, if applicable, in a collective agreement.

A non-compete provision for the period *after* the termination of employment may often be held unenforceable if structured without an element of reasonable compensation. During the term of the employment, employees are bound by strict principles of non-competition and loyalty

A buyer will need to consider exposure to environmental liability if the target's business owns or leases real property, as there is no ultimate statute of limitation.

A foreign investor may often wish to ask the target company to give certain representations about itself and its business. This is generally not permitted under Swedish law, and an investor must find other avenues for comfort, *e.g.,* representations may be given by shareholders or third party indemnities may be sought.

### F. United States

In the U.S., the range of considerations in mergers and acquisitions spans the widest possible dimensions.

#### (i) Political and Social

A comprehensive analysis of political implications should be undertaken well in advance of any acquisition proposal for a U.S. business. In the U.S., many parties and stakeholders have potential leverage (economic, political, regulatory, public relations, *etc*.) and, consequently, it is important to develop a plan to address anticipated concerns that may be voiced by these stakeholders in response to the transaction. Most obstacles to a cross-border deal are best addressed in partnership with local players (including, in particular, the target company's management, where appropriate) whose interests are aligned with those of the acquirer, since local support reduces the appearance of a foreign threat. It is, in most cases, critical that the likely concerns of federal, state and local government agencies, employees, customers, suppliers, communities and other interested parties be thoroughly considered and, if possible, addressed prior to any acquisition or investment proposal becoming public.

#### (ii) Transaction Structures

Acquirers should be willing to consider a variety of potential transaction structures, especially in sensitive deals. Structures that may be helpful in particular circumstances include no-governance and low-governance investments, minority positions or joint ventures, possibly with the right to increase to greater ownership or governance over time; making the acquisition in partnership with a U.S. company or management, or in collaboration with a U.S. source of financing or co-investor, such as a private equity firm; or utilizing a controlled or partly-controlled U.S. acquisition vehicle, possibly with a board of directors having a substantial number of U.S. citizens and a prominent American as a non-executive chairperson.

Use of preferred securities (rather than ordinary common stock) or structured debt securities should also be considered. Even more modest social issues, such as the name of the continuing enterprise and its corporate seat, can affect the perspective of government and labor officials.

### (iii) Acquisition Currency

While cash remains the predominant (although not exclusive) form of consideration in cross-border deals, non-U.S. acquirers should think creatively about offering U.S. target shareholders securities that allow them to participate in the resulting global enterprise. For example, publicly listed acquirers may consider offering existing common stock or depositary receipts (*e.g.*, ADRs) or entering into dual-listing arrangements. When target shareholders will obtain a continuing interest in an acquirer or surviving corporation that was not already publicly listed in the U.S., the board and management of the non-U.S. party should expect greater focus on the corporation's governance and other ownership and structural arrangements—relative to non-U.S. jurisdictions—including heightened scrutiny on large shareholders, especially any *de facto* controllers or promoters. That said, it is important to note that non-U.S. companies listed and traded in the U.S. are frequently not exposed to the full panoply of regulation of the U.S. Securities and Exchange Commission ("SEC") and stock exchange rules applicable to domestic companies and that listing, liquid trading and access to the capital markets in the U.S. continues to offer a variety of advantages. To the extent cash is part of the acquisition currency, given the time necessary to complete a cross-border transaction, appropriate currency hedging should be considered.

### (iv) Financing

Ongoing volatility in the credit markets has increased scrutiny on the financing aspects of transactions. Important questions to consider include: where financing with the most favorable terms and conditions is available; how committed the financing is; which lenders have the best understanding of the target's business; whether to explore alternative, non-traditional financing sources and structures, including seller paper; and how comfortable the target will feel with the terms and conditions of the financing. Note that under U.S. law, unlike the laws of some other countries, foreign acquirers are not prohibited from borrowing from U.S. lenders, and they generally may use the assets of U.S. targets as collateral. Likewise, the relative ease of highly structured financing in the U.S. market should be a benefit to the incoming acquirer, with both asset-based and other sophisticated securitized lending strategies relatively easy to implement and available in the market.

## VI. Conclusion

As this brief survey of local issues of note in cross-border mergers and acquisitions shows, there is considerable diversity and complexity in local issues, even on fundamentals. The only sure guide is experienced local counsel.

## Endnotes

1. R.S.C. 1985, c. 28.
2. 50 U.S.C. App. 2061 et seq.
3. See 31 CFR Section 800.204(a)(1)-(10).
4. 15 U.S.C. § 18a.
5. Federal Law No. 8,884/94.
6. R.S.C. 1985, c. C-34.
7. EEA comprises the member states of the European Union together with Norway, Iceland and Liechtenstein.
8. R.S.C. 1985, c. 1 (5th Supplement).
9. *Vodafone International BV*, Writ Petition No.1325 of 2010 (Bombay H.C.).

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# Social Media and Discovery

By Howard Hunter

## I. Introduction

Lawyers are now accustomed to the discovery and use of electronic communications in litigation and arbitration. Most business firms have established policies on the use and retention of electronic communications. These policies are, in general, similar to those for traditional hard copies of documents and other records. Lawyers routinely request copies of, or access to, email and to other records that are maintained in electronic format. Forensic experts can examine hard drives to determine whether deletions have occurred, and they often can reconstruct documents thought to have been deleted either from the hard drive on an individual computer or from the company's servers.

The growing use of social media has made the situation somewhat more complicated. About half a billion people have Facebook accounts. Millions use Twitter, MySpace, LinkedIn or other forms of communication. The hundreds of millions of messages, photos, and documents posted on social media pages are not necessarily controlled or stored by a specific organization or firm that is easily brought into the discovery process.[1] Sometimes the content of a profile on a social media platform may come as quite a surprise to the organization which employs an individual. The Government of the United Kingdom, for example, was embarrassed by the postings on the family Facebook page of a senior member of the British intelligence community. There can be a wealth of information in such postings, much of which may be useful in litigation or arbitration. If a claimant in a personal injury case seeks damages for a disabling injury and, at the same time, posts a photo showing him running in a 10k race, the defense will want to use the post to question the credibility of his claim. One can think of many other possibilities.

But how does one gain access to such information and how can such information be brought into the discovery process? The postings may not be in the control of a party to the litigation, and the records may be with a third party, such as Facebook, which has a confidentiality agreement with its clients.

The use of telephone-based applications has soared in the past few years. Communications via SMS or other cell phone to cell phone applications create another layer of complexity. Such messages are not stored in a server in the same way as email. Instead a message sent from a mobile device goes to a tower that is maintained by one or another of the cell phone service providers and travels along the system until it is received by another mobile device. If the receiving device is turned off or out of a service area, the message will be "held" by the service provider until it can be delivered, but, once delivered, the contents of the message often are not kept by the service provider, or only kept for a short time. The contents may remain within the sending mobile device and the receiving mobile device for a time, but most devices write over older messages after a certain volume of messages. In any event, the sender or receiver can delete the contents easily. The service provider does maintain metadata which show the identity of the sending device, the time of the message, the identity of the receiving device and the time of delivery. With relatively little effort the geographic routing of the message can be determined if the message is sent along its way pursuant to a standard contract with a provider. If the sender (or receiver or both) uses a SIM card and disposes of the card, tracking can be much more difficult.[2]

Considering the number of mobile devices currently in use and the rapidity of technological advances in applications for mobile devices, it is likely that discovery of text messages and other communications sent from one mobile device to another will become the next big area of discussion.[3]

This article examines a few of the more interesting recent cases and highlights problem areas for practicing lawyers. The technology is developing so rapidly that every lawyer needs to be up to date about methods of communication before discovery begins so that clients can be advised properly and the litigation process can proceed smoothly and fairly.[4]

Personal privacy issues often arise in connection with e-discovery. There have been discovery disputes for decades about information that is confidential or proprietary, but the problems are magnified when discovery reaches into personal computers, BlackBerrys, smart phones and other devices. An individual may have information relevant to the litigation on his or her PC, but that PC is likely to contain a great deal of other information, such as personal passwords, tax information, and medical records. Communications from one cell phone or other mobile device to another are not, in any real sense, different from telephone conversations, and the expectations of privacy may be similar. The expectation of privacy obviously varies between a personal cell phone and a company provided cell phone. Postings on a Facebook profile can hardly be said to be confidential, but there may be some difference between those posted openly and those posted on a limited access portal. This article does not deal with privacy issues in any detail, but a careful lawyer will want to consider them during the process of discovery.

## II. General Discovery Standards

### A. Relevance

The usual requirement of relevance must be shown, no matter whether the information requested is in one electronic format or another. A good discussion of the relevance issues appears in *EEOC v. Simply Storage Management, LLC*,[5] a 2010 decision from the Southern District of Indiana. The EEOC brought an action on behalf of certain employees alleging sexual harassment and seeking damages for severe emotional distress and post-traumatic stress. The defendant wanted discovery of the social network sites of the employees. The court agreed that postings on their social network sites might contain information relevant to their claims for damages, but denied wholesale access to their sites. Instead, discovery was limited to postings, messages, photographs and other information which related generally to their emotional health in the relevant time period. The court agreed with the defendant that the employees' privacy expectations were minimal. The information requested already had been disclosed to at least one person (if in a message to one individual) and, in most instances, to a number of people through postings.[6]

The plaintiff in a personal injury case was required to allow access to content on her social networking sites. She sought damages for injuries that, according to the complaint, caused her to remain inside her house and, for much of the time, in her bed. The defendant was able to counter the plaintiff's damages arguments with photographs from her MySpace and Facebook profiles which showed her outdoors and looking happy.[7] Similarly, a claimant for social security disability income based on his asthma was challenged by a Facebook posting in which he was shown smoking a cigarette.[8]

Perhaps the broadest definition of relevance in e-discovery came from a Canadian court. The plaintiff alleged that the defendants stole trade secrets and other proprietary information. The court allowed forensic experts to have access to all PCs, BlackBerrys, smartphones, Androids and other mobile devices of all relevant employees *and* of the spouses and children of those employees.[9] It is understandable that discovery of communications from the personal PCs and mobile devices of the relevant employees could be useful. If they did, in fact, steal trade secrets, it is unlikely that they used the company's own computers to accomplish the theft because an evidence trail would remain in the company's servers. Extending the discovery to PCs and mobile devices of the employees' spouses and children was exceptionally broad.

### B. Burdensomeness

The problem of burdensomeness is no less an issue with e-discovery than with traditional document discovery. How is the volume to be handled? Electronic data can be stored easily on small devices such as thumb drives, but someone has to look at the information and decide what is or is not relevant. It may be more pleasant to sit in a comfortable office with a computer than to rummage through filing cabinets in a dusty warehouse, but that improvement in comfort level does not reduce the amount of time and work needed to sift through thousands of pages. Some discovery may be aided by search engines that are programmed to look for certain keys. These may be especially useful in financial or accounting cases. But for most cases, paralegals and associates will be tasked to do the sifting and sorting. Courts have applied the traditional requirements of specificity and clarity, which are meant to minimize the burdensomeness of requests.

For example, a request that, as made, would have required the production of the recorded contents of 463,000 telephone calls was denied as burdensome. The requesting party had reason to seek information about the contents of some telephone calls but the request was much too broad and it had to be re-framed to be more specific and detailed.[10]

In another case, one party asked for information from an opposing party's PC. The information requested was relevant, and the responding party provided a thumb drive with all the relevant files. The requesting party then demanded a forensic image of the hard drive to check against the thumb drive in order to be certain that everything relevant had been copied and that nothing had been deleted. The respondent objected because the hard drive contained a great deal of purely personal information such as tax records, SSANs, and credit card information. The court agreed with the respondent and said that the requesting party should first examine the files on the thumb drive. If not satisfied with that information, then the requesting party would have to lay a proper foundation for seeking more information from or about the hard drive.[11]

### C. Authentication

Authentication of the information derived from a search of the contents of a hard drive, a mobile phone, or a Facebook posting can be tricky. Identifying the computer or mobile device from which a message was sent or which received a message may not be so difficult, but how is one to know that the sender or receiver is the person relevant to the litigation? A good forensic investigator may be able to determine that a third party hacked into a computer, but what if a third party simply had access to the relevant individual's cell phone or PC? This problem seems to have arisen most often in criminal cases, but it could occur in any case. Authentication is primarily an issue when introducing evidence, but authenticating a posting or an e-message during discovery can avoid subsequent problems.

A recent Maryland decision provides a good example of inadequate authentication. At issue was the use of a MySpace post as evidence in support of a charge of threatening prosecution witnesses. The girlfriend of a defendant named "Boozy" was alleged to have posted a MySpace message on her profile which said, "Free Boozy!!! Just remember snitches get stitches!! U know who you are!!" The prosecution alleged that the posting was a threat to witnesses against the defendant. The girlfriend was put on the stand and examined about a number of issues but she was not asked to identify or to verify the posting. The only attempted verification came from a police investigator who based his authentication on the appearance of the post and its accompanying pictures and the fact that it was on the girlfriend's profile page. The court noted, however, that the post could easily have been made by anyone who had access to the profile, such as a friend of the person who established the site or someone who knew the password. For proper authentication, the prosecution should have asked the girlfriend directly about the post and sought to have her authenticate it.[12]

Authentication issues can arise in any dispute, but they may be especially important in criminal cases. The burden of proof is higher and the prosecution usually must prove the mental state—the level of intentionality—of the defendant. Text messages, as well as e-mails and social media postings, can be helpful to the prosecution, but only if properly authenticated. In a North Dakota case a wife was convicted of simple assault on her husband, in part because of text messages which showed her state of mind.[13] In Virginia a defendant was convicted of knowingly communicating a written threat because of postings on his MySpace profile that talked about killing his former girlfriend and kidnapping their child.[14] A woman and her boyfriend were convicted of murdering the woman's estranged husband, and text messages they exchanged around the time of the murder were important evidence for the prosecution.[15]

## III. Knowing What to Request

A proper discovery request for social media content, text messages, and similar items should be as specific as possible, which means that lawyers must be up to date on technological developments.[16] Asking for the e-mails of a company or an individual may be routine, but knowing how to ask the right questions to get to additional relevant materials may not be so simple. A requesting attorney may, for example, inquire whether the respondent uses or has used various "wipeclean" or other prophylactic programs. One named "TigerText" is useful for the protection and deletion of text messages. Depending on how it is set to perform, it can allow deletion on demand or automatically after a set time, and it can prevent messages from being saved, copied, or forwarded by the recipient.[17] A person who uses a program such as TigerText may be interested in nothing more than personal privacy and the use may be no different from physical destruction of written materials on a regular basis. However, the use of such a program may contravene a company's policy on document retention if the mobile device is used for company business, or, if used by a government employee, the program may violate various open records laws.

A responding party will be presumed to act in good faith and to provide the information requested, but the requesting party should be prepared to lay a foundation for seeking to verify the responses by doing a forensic examination of the respondent's hard drive or mobile device, including any SIM cards used by the respondent.[18] If there is forensic evidence of the use of a "wipeclean" program or of deletions contemporaneous with the request or other relevant events, then there might be a basis for seeking an "adverse inference" charge.[19] In an employer's action against former employees for misappropriation of trade secrets, a forensic examination of the employees' mobile devices showed that there were no saved data because the devices had been deliberately wiped clean. The evidence of deliberate wiping supported an adverse inference charge.[20] Ironically, if the former employees had simply waited a while after sending the messages that were worrisome, the devices probably would have overwritten the messages without any indication of deliberate deletion. Metadata stored by the cell phone service provider would have shown the time and date of messages as well as the numbers of the sending and receiving devices, but without the content there would be no way to show that the messages were not innocent communications about lunch or golf dates or routine business. Deliberate, contemporaneous deletion suggested the possibility of a guilty conscience.[21]

The requesting party should know, as well, whom to ask for relevant information. In many instances, most often those involving mobile devices, the best source of information may be a third-party service provider, such as cell phone company.[22] Text messages provided by Verizon in response to a subpoena were important to the prosecution's case in achieving a murder conviction of two defendants.[23] In a copyright infringement case, a federal court allowed early discovery of information from eight different service providers used by the proprietors of an online Korean pop music website.[24]

The growth of cloud computing will add further complications. If an organization owns and controls its servers, then a request for data to that company should be sufficient to obtain pertinent records from the company's own e-storage files. But if the organization uses cloud computing, then the relevant data may be under the direct control of one or more third parties and in various e-storage locations. The data should still be available, subject to policies on retention and deletion, but the process of identifying the location of data and the specific identity of the party with custodial responsibility may not be so simple.

## IV. Awareness of Cultural Differences

The rapid increase in international trade during the past thirty years has seen a similar increase in the number of cases and arbitrations which involve parties from varying jurisdictions. Those who are involved with litigation and arbitration must be aware, as well, of cultural differences in the uses of various forms of electronic communications. Having lived and worked in Southeast Asia for the better part of a decade, this author's own observations indicate that the use of text messaging is greater in the Asian business world than in North America or Europe. The use of social media has increased dramatically in recent years, but substantive business communications seem to occur most often—at least for the time being—through text messaging as well as e-mail. An unscientific survey of recent decisions from the jurisdictions of Singapore and Malaysia disclosed that but a single case mentioned "social media" in the context of evidence while two hundred twenty cases mentioned "sms."[25] This small sampling does not mean that social media postings may not contain relevant information useful to litigants in an Asian jurisdiction. It simply indicates that it is important to be aware of the degree to which the population in one region or the other prefers a particular form of electronic communication and to organize discovery requests that recognize varying preferences and behaviors. The portability of mobile devices and the rapid increase in the availability of sophisticated applications for such devices means that they are likely to increase in popularity in those areas where business people are especially mobile. They are inexpensive and it is easy to upgrade from one device to another frequently, which also causes problems for discovery because the technology changes as rapidly as the mobile devices.[26]

Keeping up to date on the many variations among jurisdictions on privacy of communications is important as well. This article does not address privacy issues, except in the most general way, but different regimes have different requirements and expectations. The rules are evolving almost daily. In the midst of the controversy in the United Kingdom about newspapers which are alleged to have hacked into private cellphones and other electronic devices, the UK courts are considering new rules on the use of mobile devices, e-mail, social media and Internet-enabled laptops within the courts themselves.[27]

## V. Statutory Issues and Ethical Concerns

The Stored Communications Act of the United States[28] prohibits unauthorized access to stored electronic communications and data. The statute is meant to protect the privacy of those who depend upon third parties for the storage of electronic data, such as the users of Yahoo or Google email, as well as many more. The elements of a claim in a civil case for violation of the Act are that:

- The defendant intentionally accessed a facility in which an e-communication service is provided; and
- The access was not authorized or the degree of access exceeded that which had been authorized; and
- The defendant obtained, altered, or prevented authorized access to an e-communication in electronic storage in the system; and
- The defendant's unauthorized access caused actual harm to the plaintiff.[29]

The four requirements indicate that hackers are certainly among those targeted by the legislation, but the extent to which the Act is an impediment to discovery is unclear. A holder of e-communications cannot knowingly divulge the contents to a third party without the consent of the person who created or sent the communication, but the particular contractual relationship between the storage party and the sending party may authorize disclosures, at least to some extent, in litigation contexts. Some years ago the Florida Supreme Court held that a trial court could order parties to sign authorizations to allow access to medical records in cases in which medical records were relevant.[30] Once the information is available (by whatever means), the Act does not prohibit its disclosure or use:

> The Act prohibits only unauthorized *accessing* of stored electronic communications. Section 2701 does not proscribe unauthorized use or disclosing of that communication, even if obtained by unauthorized access.[31]

Another federal court recently held that it is not a violation of either the Wiretap Act or the Stored Communications Act for Facebook to disclose to its advertisers the basic personal information posted by Facebook registrants when a user clicks on an advertisement.[32]

Although the Stored Communications Act may not be a major roadblock to discovery, it is something a lawyer should take into account when seeking information from a third party. If the parties agree that electronic communications may be relevant and discoverable, then access through a third party may be made easier by an agreement to authorize such access, subject to the usual requirements of relevance, reasonableness, and protection of legitimate privacy interests.

In the meantime, a good lawyer will advise his clients not to engage in "self-help." An employee sued her employer for sexual harassment, and the employer counterclaimed for business torts. During the litigation it came out that the plaintiff's boss had accessed, without authorization, the plaintiff's AOL account by using her password. The jury was not amused by the unauthorized entry into the plaintiff's personal e-mail account

and awarded her $400,000. The award was affirmed on appeal.[33]

Lawyers should follow their own advice and not try to engage in surreptitious discovery by "friending" an adverse party on a social media platform or by "stalking" a party. State ethics panels have looked specifically at such issues. In New York, it is permissible for a lawyer to examine the public pages of a party's social media profile. That is essentially no different from using a clipping service to gather information from newspapers, magazines, and other public sources. (Today that would obviously include a Google search and a look at a relevant Wikipedia entry.) It is *not* permissible to circumvent the privacy controls installed by a registrant on a social media portal or to use a third party to do so or to become a "friend" (directly or through a third party) under false pretenses.[34]

How one uses electronic communications personally or professionally can create problems as well. A Singapore lawyer was disciplined for "conduct unbecoming a lawyer" for the content of SMS messages sent to the complainant.[35] Postings made by a Savannah firefighter on her MySpace profile caused her to be disciplined for unprofessional conduct.[36] Communications by e-mail and SMS during the unhappy breakup of a partnership in the jewelry business led to counter-defamation actions.[37] There is a small but growing cottage industry involved in identifying anonymous bloggers and similar users of electronic communications who defame or disparage businesses, products, or individuals.[38] The moral of these various cases is that the choice to use electronic communications does not necessarily shield one's identity nor protect one against liability for the content of the communications. Professional ethics and common sense are both important.

## VI. Client Advice

In the normal course of providing advice to clients, lawyers should make sure that clients are aware of the ways in which social media and other forms of electronic communications—beyond traditional e-mail—can be used. Employers should have explicit policies in place about the use—or non-use—of social media, text messages and other forms of electronic communication in connection with the employer's business or other activities. Employers should be made aware that an employee's use of social media, even on a personal account and not during working hours, may be discoverable in litigation if the content is relevant to the employer's business and to whatever the issue may be in a particular dispute. If the organization is professional in nature (law firm, accountancy firm, medical practice, etc.) or if there is substantial public interest in the quality and integrity of the employees (firefighters, police, teachers, civil servants), there may be good reasons for the employer to publish rules about the use of social media in the employee's personal capacity.

Lawyers should be especially careful about the use of social media. Personal use may affect a lawyer's professional reputation and credibility. Of course it is always true that what a lawyer does in his or her personal life may affect reputation in the community, but the use of social media can have a multiplying effect. That "cute" post of a party at the beach may not be so cute when it goes viral on You Tube.

Furthermore, the misuse of social media can lead to ethical problems. As noted above, an aggressive attempt to learn more about an adverse party through social media sleuthing can violate ethical standards. Firms should have clear policies in place and those policies should be communicated clearly to all the lawyers and support staff. The same should be true for public lawyers and court staff.

## VII. Useful Additional Resources

There are many articles, websites, and blogs which contain useful information about social media. Some provide technical details that can help lawyers understand how to go about discovery and how to protect legitimately private information. Others provide helpful updates on recent cases. The various law review articles tend to cover broader issues and also contain references to many cases and other secondary sources. Bear in mind that bloggers and website creators often write from a particular perspective, but with that note of caution, blogs and websites contain huge amounts of detailed information. Set forth on Appendix A are a few suggestions for further reading. Some of these articles have been cited in the notes to this article.

## Endnotes

1. Even the United States Government now has a Facebook page, as do many private businesses. Such pages are presumably within the control of the organization and discovery should follow the same general road as that for email and similar electronic communications.
2. For a discussion of these kinds of issues, see the useful website www.fulcrum.com, especially, www.fulcrum.com/text-messages.htm (Detjen 2011).
3. *See generally* Donlin, *Want to be Facebook Friends? The Growth of Social Media and Its Potential Impact on Legal Proceedings in Connecticut*, 22 CONNECTICUT LAW. 23 (2010); Pengelley, *Fessing Up to Facebook: Recent Trends in the Use of Social Network Websites for Civil Litigation*, 7 CANAD. J. L. & TECH. 319 (2010); Prignano and Fishkin, *Social Networking*, N.Y.L.J. (15 Nov. 2010).
4. For an analysis of the effects of the 2006 amendments to the Federal Rules, *see* Borden, McCarroll, Vick, and Wheeling, *Four Years Later: How the 2006 Amendments to the Federal Rules Have Reshaped the E-Discovery Landscape and Are Revitalizing the Civil Justice System*, 17 RICH. J. L. & TECH. 10 (2011).

5. 270 F.R.D. 430 (S.D. Ind. 2010). (For a somewhat similar case, *see Bass v. Miss Porter's School*, 2009 U.S. Dist. Lexis (D. Conn. 2009).
6. *Id.*, c*iting Mackelprang v. Fidelity National Title Agency of Nevada, Inc.*, 2007 WL 119149 (D. Nev. 2007).
7. *Romano v. Steelcase, Inc.*, 907 N.Y.S.2d 650 (Sup. Ct. 2010). *See also Ledbetter v. Wal-Mart Stores, Inc.*, 2009 WL 1067018 (D. Colo. 2009).
8. *Purvis v. Commissioner of Social Security*, 2011 WL 741234 (D.N.J. 2011).
9. *CIBC World Markets, Inc. v. Genuity Capital Markets* [2005] O. J. No. 614 (S. C. J.)(QL).
10. *General Steel Domestic Sales, LLC v. Chumley*, 2011 US DIST LEXIS 63803 (D. Colo. 2011).
11. *Hansen v. Chevron USA, Inc.*, 2011 US DIST LEXIS 58488 (D. Utah 2011).
12. *Griffin v. State*, 419 Md. 343, 19 A.3d 415 (2011). *See also Dickens v. State*, 175 Md. App. 231, 927 A.2d 32 (2007); *Commonwealth v. Williams*, 456 Mass. 857, 926 N.E.2d 1162 (2010); *People v. Lenihan*, 30 Misc. 3d 289, 911 N.Y.S.2d 588 (Sup. Ct. 2010).
13. *State v. Thompson*, 2010 N.D. 10, 777 N.W.2d 617.
14. *Holcomb v. Commonwealth*, 58 Va. App. 339, 709 S.E.2d 711 (2011).
15. *State v. Canady*, 161 Wash. App. 1009, 2011 WL 1459733 (18 April 2011).
16. *See*, *e.g.*, Watson and Fendell, *The Art of War and E-Discovery Lesson 1: Be Prepared*, eDiscovery News, 23 March 2011.
17. *See* eDiscovery News, 1 March 2010.
18. *See*, *e.g.*, *Hansen v. Chevron USA, Inc.*, 2011 U.S. Dist. Lexis 58488 (D. Colo. 2011), on the need for establishing proper foundation for a forensic examination.
19. *See*, *e.g,. U.S. v. Anthony Suarez and Vincent Tabbachino*, 2010 U.S. Dist. Lexis 112097 (D. N. J.)
20. *Southeastern Mechanical Services, Inc. v. Brody*, 657 F. Supp. 2d 1293 (M. D. Fla. 2009).
21. *See*, *e.g.*, *Foust v. McFarland*, 698 N.W.2d 24 (Minn. 2005).
22. In a private conversation with the General Counsel of a major, international telecommunications firm, the counsel indicated to this author that the company routinely provides to requesting litigants or arbitration parties the metadata (and content if available) of text messages. He indicated that most of these requests come in connection with domestic litigation, such as divorce and child custody cases, or in connection with personal injury claims or routine contract disputes. Content may be subject to some degree of privacy protection, but there is little protection in the jurisdictions where this company operates for metadata on communications between mobile devices. The telecommunications firm prefers to cooperate, subject to the reasonableness of requests, rather than to become tangled up in the discovery disputes of third parties. It is likely that different telcos and different IT companies have varying policies on how to respond, as a general rule, to third-party discovery requests. Some may demand a subpoena.
23. *State v. Canady*, 161 Wash. App. 1009, 2011 WL 1459733 (18 April 2011).
24. *DFSB Kollective Co. v. Jenpoo*, 2011 US DIST LEXIS 62163 (N.D. Cal. 2011).
25. This search was conducted through Law Connect, a database of Singapore and Malaysian cases (and those from several other common law jurisdictions) maintained by the Law Society of Singapore. Both Singapore and Malaysia are common law jurisdictions and both have large caseloads of substantial commercial litigation.
26. A note of caution: Japan and Korea use different mobile technologies from most other countries, which means that the party seeking discovery must have be aware of the differences and the technology necessary to track data. With the growth of 4-G availability, some of these differences are of less consequence now.
27. Senior Courts Practice Guidance: (Court Proceedings: Live Text-Based Communications) [2011] 1 WLR 61.
28. 18 USC §2701 *et seq.*
29. *Cornerstone Consultants, Inc. v. Production Input Solutions, LLC*, 789 F. Supp. 2d 1029 (N.D. Ia. 2011). Violation of the Act can lead to criminal sanctions in addition to civil liability.
30. *Rojas v. Ryder Truck Rental, Inc.*, 641 So. 2d 855 (Fla. 1994).
31. *Perloff v. Stein*, 2011 WL 666167 (E.D. Pa. 2011), *citing Wesley College v. Pitts*, 974 F. Supp. 375 (D. Del. 1997), *aff'd*, 172 F.3d 861 (3d Cir. 1998) (emphasis in original).
32. *In re Facebook Privacy Litigation*, 791 F. Supp. 2d 705 (N.D. Cal. 2011). Facebook protocols require that a registrant use his or her real name and e-communications identity.
33. *Van Alstyne v. Electronic Scriptorium, Ltd.*, 560 F.3d 199 (4th Cir. 2009).
34. New York Commission on Professional Ethics, Op. 843 (10 September 2010). *See also* New York City Commission on Professional Ethics, Formal Op. 2010-2; Philadelphia Professional Guidance Commission, Op. 2009-02 (March 2009).
35. *The Law Society of Singapore v. Kirpal Singh s/o Hakam Singh*, [2010] SGDT 5.
36. *Marshall v. Mayor of Savannah*, 366 Fed. Appx. 91, 2010 US APP LEXIS 3233 (11th Cir. 2010).
37. *Segar Ashok v. Koh Fonn Lyn Veronica and ano*ther, [2010] SGHC 168.
38. See Michelle Sherman, *Anonymous Bloggers and the First Amendment: When and How Your Company Can Identify Its John Doe Defendants*, post of 25 July 2011, www.socialmedialawupdate.com.

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## Appendix A


Steven C. Bennett, *Civil Discovery of Social Networking Information*, 39 S.W. L. Rev. 413 (2010).

Aaron Blank, *Comment: On the Precipice of E-Discovery–Can Litigants Obtain Employee Social Networking Web Site Information Through Employers?* 18 Comm. L. Conspectus 487 (2010).

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Eric Danowitz, *MySpace Invasion: Privacy Rights, Libel, and Liability*, 28 J. Juv. L. 30 (2007).

Margaret M. DiBianca, *Ethical Risks Arising from Lawyers' Use of (and Refusal to Use) Social Media*, 12 Del. L. Rev. 179 (2011).

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Sandra Hornberger, *Social Networking Websites: Impact on Litigation and the Legal Profession in Ethics, Discovery, and Evidence*, 27 Touro L. Rev. 279 (2011).

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Samantha L. Miller, *The Facebook Frontier: Responding to the Changing Face of Privacy on the Internet*, 97 Kentucky L.J. 541 (2008-09).

Katherine Minott, *The Advent of Digital Diaries: Implications of Social Networking Web Sites for the Legal Profession*, 60 S.C.L. Rev. 1057 (2009).

Evan E. North, *Facebook Isn't Your Space Anymore: Discovery of Social Networking Websites*, 58 U. Kan. L. Rev. 1279 (2010).

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Ken Strutin, *Social Media and the Vanishing Points of Ethical and Constitutional Boundaries*, 31 Pace L. Rev. 228 (2011).

Lisa Thomas, *Social Networking in the Workplace: Are Private Employers Prepared to Comply with Discovery Requests for Posts and Tweets?* 63 SMU L. Rev. 1373 (2010).

Kathleen Elliott Vinson, *The Blurred Boundaries of Social Networking in the Legal Field: Just "Face It,"* 41 U. Memphi. L. Rev. 355 (2010).

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# Social Networking and the Law: Virtual Social Communities Are Creating Real Legal Issues

By Rory J. Radding

## I. Introduction

Millions frequent social networking platforms such as MySpace, Facebook, YouTube, and Second Life in their daily lives to play interactive games, chat, send messages, and post videos and pictures among an infinitely expanding list of online interactive venues and options. This article addresses three pressing legal challenges that social networking Web site operators face in the development and maintenance of their Web sites: defining and establishing the terms of use for the online service; protecting intellectual property; and maximizing the statutory immunities available to site operators.

## II. End-User License Agreements

The End-User License Agreement (EULA, often labeled the site Terms of Service or Terms of Use) sets forth the terms and conditions of Web site use and acts as a Web site's first line of defense to end-user-related claims. EULAs received national attention in a recent criminal trial involving Lori Drew, who was accused of creating a fictional MySpace account for the purpose of harassing her 13-year-old neighbor, Megan Meier, who allegedly committed suicide as a result of Ms. Drew's cyberbullying.[1] Specifically, Ms. Drew was charged with conspiring to violate the terms of MySpace's EULA, which prohibits both the creation of fictitious accounts with false information and the use of the Web site's services to harass other members. On 26 November 2008, Ms. Drew was convicted by a federal jury on three misdemeanor charges of computer fraud for accessing a computer without authorization.

The means of presenting the Terms of Use to the end user is a critical threshold consideration for social networking sites, requiring a balance of technical, legal, and unique business considerations. Technically, options for presenting the terms range widely, from merely displaying a hyperlink on the Web site without collecting any identifying information or consent, to a "clickwrap" agreement that requires users to provide full contact information on a registration page and to affirmatively click "I agree" only after being visually presented with all the terms of the agreement. There are many options in between these extremes. As a legal matter, courts may conclude that no binding agreement was ever formed unless the site's registration process includes a step where the user has expressed a "manifestation of assent" to be bound by a conspicuously displayed agreement.

Although legally quite effective, many online businesses conclude that a multistep formal clickwrap registration process is too intrusive and legalistic, thereby deterring potential users from following through with the registration process. Many sites thus opt for intermediate means of collecting assent, such as asking users to acknowledge that they have read the Terms of Use, which are available for review but not required to have been actually viewed. At the end of the day, the means of presenting the EULA and collecting evidence of consent is a decision that balances business and law, as efficiency of the registration process is weighed against the need to create a legally binding agreement.

Assuming the court concludes a contract was formed, it will look to the actual terms of the agreement to determine if the contract is enforceable in whole or in part. Many courts have ruled that EULAs are contracts of adhesion because subscribers are presented only the opportunity to accept or reject the terms in their entirety. In deciding whether to enforce such agreements, courts typically apply a heightened scrutiny to both the manner in which such an agreement is formed and the reasonableness of the substantive terms.

A finding of adhesion thus begins another inquiry—whether a particular provision within the contract should be denied enforcement on grounds that it defeats the expectations of the weaker party or is unduly oppressive or unconscionable. Courts may refuse to enforce a contract or a specific contractual provision if the clauses involved are so one-sided as to be unconscionable under the circumstances existing at the time the contract is made. To be unenforceable, a contract must be both procedurally and substantively unconscionable. Contracts of adhesion are per se procedurally unconscionable because they do not provide any meaningful opportunity for negotiation and leave the user with no reasonably available market alternatives. Substantive unconscionability focuses on whether the terms are unreasonable. Because a contract is largely an allocation of risks, a contractual provision is substantively suspect if it allocates the risks in an objectively unreasonable or unexpected manner.

EULA provisions commonly rejected by courts on grounds of unconscionability include mandatory arbitration provisions, forum clauses, and prohibitions on class actions. For example, a court has held the arbitration clause contained with the EULA for a social networking Web site, Second Life, to be invalid on the grounds that the provision was both procedurally and substantively unconscionable.[2] In light of this decision, those developing social networking Web sites should take care in drafting their EULAs to avoid invalidation of their terms.

As a social networking Web site matures, its business and the ever-changing legal environment are likely to prompt revisions to the standard posted EULA terms. Whether and how such modified terms can be enforced against prior registrants is another common area of concern. Subsequent changes to the EULA may be unenforceable against users, absent reservation to modify the terms of the agreement. Accordingly, the agreement should include unambiguous language that places the obligation on the user to stay abreast of changes, and specifies that continuing use of the social network constitutes assent to any new terms. These precautionary measures are designed to prevent a user from pleading ignorance (and procedural unconscionability) when a Web site operator attempts to enforce an amended EULA against the user.

Every social networking site will have to consider some issues unique to its individual business model. In short, indiscriminate copying of and pasting from EULAs from other sites is a poor drafting choice and can lead to liability.

## III. Copyright Violations

Social networking Web sites can be hotbeds for copyright violations. The owner of a copyright has the exclusive right to do and authorize any of the following: reproduce the work; prepare derivative works; distribute copies of the work; perform the work publicly; and display the work publicly. In the event that any one of a copyright owner's rights is infringed, the law provides for criminal sanctions and civil liability against the direct infringer. Traditionally, the law also provided broadly that a copyright owner may be able to recover civil damages from social networks hosting an infringing work—in lieu of the direct infringer—under the theories of "contributory infringement" or "vicarious liability."

Recognizing the need to address modern copyright issues, Congress enacted the Digital Millennium Copyright Act (DMCA) in 1998.[3] The DMCA provides a safe harbor to "service providers" (e.g., social networks), protecting them from secondary criminal and civil liability. Under the DMCA, social networks will be held harmless so long as three conditions are met: (1) lack of actual knowledge of infringement, or lack of awareness of facts or circumstances from which infringing activity is apparent; (2) lack of financial benefit directly attributable to the infringement, where the service provider has the right and ability to control such activity; and (3) expeditious takedown of infringing material after notice has been appropriately given.

Copyright law in the social networking context remains in flux because courts are facing difficult issues arising out of rapidly advancing and evolving technology. The ease with which Internet users are able to distribute copyrighted information has dramatically increased the prevalence of copyright infringement. Copyright law is being stretched to its limits in order to determine how best to protect copyright holders as well as Internet Web sites that merely host information.

Thus, until a resolution is reached, a Web site operator should take extra precautions to ensure protection under the safe harbor provisions of the DMCA. To accomplish this end, social network operators should draft an EULA that accomplishes dual purposes: (1) prevent direct infringement by users; and (2) take appropriate measures upon discovery of infringement. To prevent direct infringement, operators should warn users of possible civil and criminal consequences of uploading copyrighted material. If individual users are found to violate repeatedly copyright policies, the EULA should warn that users will be prevented from future use of the social network. The EULA also should name an agent charged with the responsibility of receiving notices and initiating the prompt takedown of infringing material pursuant to the DMCA. Lastly, it is best that social networks refrain from placing any profit-generating advertisements in the same place where copyright violations occur. Drafting an EULA with this two-prong approach in mind will be helpful in crafting an agreement that will provide a solid defense to copyright infringement attacks under secondary liability theories.

## IV. Trademark Violations

A trademark encompasses virtually anything—word, number, name, nickname, phrase, symbol, device, logo, color, sound, scent, or design—that is used by a company to identify its goods or services, and to distinguish them from goods or services manufactured by others. The owner of a trademark may generally exclude subsequent users from using that mark or a confusingly similar mark for the same or related products or services. If another company uses a confusingly similar mark on the same or related products or services, the trademark owner can file a claim for trademark infringement, which requires a showing that there is a "likelihood of confusion" between its trademark and the allegedly infringing mark. An owner of a "famous" trademark also has the ability to protect against the use of its mark on any product or service that dilutes its distinctive quality either through blurring or tarnishment of the mark. This is called trademark dilution.

Due to the nature of content generated by social networking Web sites, it is difficult, if not impossible, for a social networking Web site to weed out infringing trademark usage by users. Similar to secondary liability for copyright infringement, social networks may be open to attack under the theory that the network is allowing its users to engage in trademark infringement and dilution on the network. However, the Lanham Act provides a safe harbor for social networking Web sites—so long as the social network is an "innocent infringer." To qualify as

an innocent infringer, the social network must establish that (1) it did not actively induce or participate in the infringement and (2) it did not have specific knowledge of its users' infringement.

The innocent infringer defense was examined by a federal district court in California when eBay was sued by a trademark owner, who claimed that eBay was allowing users to display pictures and sell pirated copies of his movie through the Web site.[4] The court held that eBay qualified as an innocent infringer because it did not actively induce or participate in infringement and it did not have specific knowledge of its users' infringement. Perhaps more significantly, the court refused to place an affirmative duty on eBay to monitor and remove future infringing advertisements on its Web site.

Practically, the significance of the *eBay* decision is that it shifts the burden of finding infringing marks posted on social networking Web sites to the owner of the trademark. This interpretation has the effect of creating a trademark safe harbor procedure for social networking Web sites that largely follows the procedures of the DMCA. Like the DMCA, it is important to realize that the innocent infringer defense does not absolve a Web site from all secondary trademark liability. It remains critical to include provisions in the EULA that track the safe harbor provisions of the Lanham Act. EULAs should contain language that prohibits the unlawful use of trademarks on the Web site and reserves the right of the Web site to block repeat offenders. It is also recommended that the Web site describe specific notice and takedown procedures.

## V. Defamation

Defamation is the publication of a false statement about another that causes harm to reputation. The ability of users on social networking Web sites to blog, comment, and message provides plenty of opportunities to publish false statements that damage the reputation of their targets. Users may be directly liable for the comments they post, but absent statutory immunities, social networking Web sites could be held liable for publishing those defamatory comments. Fortunately, federal law broadly protects Web sites that merely distribute (as contrasted with authoring) information created by a third party from liability for defamation. The issue confronted by social networking Web sites is determining where they fall within the publisher-distributor spectrum.

Early case law found Internet service providers (e.g., social networks) to be more analogous to publishers than distributors, thus holding them liable under the same standards as the author himself. Congress responded with the Communications Decency Act (CDA),[5] which provides a safe harbor from defamation claims to social networking Web sites so long as (1) the defendant is a provider or user of an interactive computer service; (2) the asserted claim treats the defendant as a publisher or speaker of information; and (3) the challenged communication is information provided by another information content provider. For a social network to shelter itself under the CDA, it is critical to avoid being classified as an "independent content provider."

Surveying recent court decisions, CDA immunity has extended even to those exercising significant editorial control over Web site content. However, the case law is fairly sparse and fact-specific, making it difficult to articulate a clear standard differentiating the roles of editor and publisher. As a general matter, providers typically will not lose their immunity if they merely exercise some control over the posting of information by others, such as enforcement of rules as to appropriate content or minor editing. Nor will they lose immunity by merely facilitating expression of information by individual members. However, it is unclear whether a social networking Web site would have CDA immunity if it influences Web site content by posing particular questions for individual members' response.

Many Web sites provide mechanisms for users to redress defamatory statements (e.g., giving users the ability to delete comments), while not affirmatively assuming the responsibility of controlling content. The best advice for social networks regarding CDA immunity is to seek the counsel of an attorney in order to define the appropriate parameters for editorial conduct based on the specific nature of their businesses.

## VI. Tread Warily

Social networking is the today and the tomorrow of the Internet. By allowing users to generate content published on social networks, the Internet is both creating new legal issues as well as putting a new spin on old issues. The legal considerations discussed here represent some of the most prevalent legal issues facing today's social networking Web sites. With billions of dollars at stake, there is great value in discovering your own company's or your client's social networking tools and adopting policies and procedures that help protect it from plausible attacks.

## Endnotes

1. *United States v. Drew*, No. 08- CR-582 (C.D. Cal. 26 Nov. 2008).
2. *Bragg v. Linden Research*, No. 064925 (E.D. Pa. 30 May 2007).
3. Pub. L. No. 105-304, 112 Stat. 2860 (1998), amending Title 17 of the U.S. Code.
4. *Hendrickson v. eBay, Inc.*, 165 F. Supp. 2d 1082 (C.D. Cal. 2001).
5. P.L. 104-104, Title V, Subtitle A, § 501, 110 Stat. 133 (1996).

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# Recent Arbitration Trends in Latin America

By Luis Enrique Graham

## I. Introduction

Over the last two decades, the tendency in a number of Latin American jurisdictions has been to become consistently more supportive of international arbitration, both in regard to the legislative framework and the approach of the local courts. There can be no doubt that positive progress has been made, as illustrated by the list of countries that have adopted national arbitration laws in line with the UNCITRAL Model Law, the international "gold standard."

As part of this tendency to "internationalize" arbitration, several countries have abandoned their former usages and practices contained in their local arbitration laws. Such usages are, for example, that arbitrations had to be conducted in the official language spoken in that given country or that the arbitrators had to be locals from the seat of arbitration.

Further, although it was not established in the arbitral laws, international arbitrations used to be conducted, both by arbitrators and the parties, in a manner similar to court litigation, since the style in which most international arbitrations are conducted was unknown. An example of this "court style" is that it was believed that the parties had to submit all of their arguments in their first statement on the merits. Another example is that the parties believed that access to documents in the possession of the opponent was denied unless the party requesting such document was able to identify, in a very precise fashion, the document it wanted.

## II. Recent Arbitral Law Reforms in Several Latin American Countries

### A. Mexico

In January 2011 an important reform in connection with commercial arbitration was promulgated in Mexico. The main purpose of the reform was to improve the Mexican regulations regarding judicial intervention in arbitration. This is a positive step, since it provides certainty in regard to certain aspects of the judicial proceeding that are related with arbitration. Moreover, such a reform preserves the well known principles of flexibility and promptness in arbitration.

The reform has a wide scope, and, among the several aspects that it covers, the following establish an important precedent for arbitration in Latin America.

#### 1. Referral to Arbitration

The reform sets forth that, if one party requests a court before which an action is brought, in a matter which is the subject of an arbitration agreement, that the controversy is referred to arbitration, the court is to suspend the judicial proceedings until the arbitral tribunal has expressed its opinion on the matter. Such a motion to refer the parties to arbitration is to be made no later than when submitting the first statement on the merits of the dispute (generally the reply to the claim). Before this reform, Mexican law on arbitration established that the parties could bring an action before a court to refer the parties to arbitration at any given moment.

Further, the reform establishes that the parties' referral to arbitrate will only be denied if there is a final resolution indicating that the arbitration agreement is null, or if the ineffectiveness of the arbitration agreement is notorious in accordance with very strict criteria.

Moreover, in order to have a prompt resolution to the proceeding that is being revised, there is no ordinary recourse available for challenging the referral to arbitration. With this amendment, the Mexican regulation is now in harmony with the formula proposed by the UNCITRAL Model Law.[1]

#### 2. Special Procedure on Commercial Transactions and Arbitration

The reform foresees a new procedure, called "special procedure on commercial transactions and arbitration," whose purpose is to solve matters related to the arbitration proceedings. Among such matters are:

- Enforcement and recognition of an arbitral award;
- Annulment of an arbitral award;
- Enforcement of interim measures ordered by the arbitral award;
- Challenge of arbitrators;
- Jurisdiction of the arbitral tribunal, when it is determined in a resolution other than the award on the merits; and
- Granting of interim measures prior to or during the arbitration proceedings.

From the latter, it is important to highlight the enforcement and annulment of arbitral awards and the enforcement of interim measures ordered by the arbitral tribunal.

#### 3. Enforcement and Annulment of an Abitral Award

The new regulation sets forth that the resolutions rendered in enforcement or vacatur proceedings may only be challenged through *amparo* proceedings. Further, the

enforcement and annulment proceedings can be consolidated in order to have the decision on both matters in only one resolution.

#### 4. Interim Measures

The granting of interim measures by an arbitral tribunal may be requested and obtained through "special procedure on commercial transactions and arbitration."

Every interim measure ordered by an arbitral tribunal will be binding upon the parties and the court may order its enforcement without going over the merits of the decision that ordered such interim measure.

In any event, if the arbitral tribunal does not establish the payment of a guarantee in order to enforce the interim measure, the judge may order such payment.

A downside of the reform is that it establishes that both the party requesting the interim measure and the arbitral tribunal ordering it are liable for damages caused by the enforcement of such measure. However, from a practical standpoint, it must be taken into account that limitation of liability in regard to arbitrator's acts is incorporated into the arbitration rules that are commonly used in arbitration in Mexico. For example, the Rules of Arbitration of the International Chamber of Commerce provide that:

> Neither the arbitrators, nor the Court and its members, nor the ICC and its employees, nor the ICC National Committees shall be liable to any person for any act or omission in connection with the arbitration.

This limitation on the arbitrators' liability is allowed by Mexican law and is consistent with the practice of commercial arbitration. Several institutions have included in their arbitration rules provisions like the one cited above. Some of those institutions are International Center for Dispute Resolution (ICDR), London Court of International Arbitration (LCIA), National Chamber of Commerce of Mexico (CANACO), and Arbitration Center of Mexico (CAM).

#### 5. Other Procedural Aspects

The reform includes a non-litigious procedure before the courts in order to implement any measure for assistance in the presentation of evidence, any inquiry about the fees of the arbitral tribunal, and the request for the appointment of arbitrators.

In connection with the last point, it is important to highlight that the court is to use a system of lists in order to appoint the arbitrators only when it is not inconvenient and when it is not agreed otherwise by the parties. The court will send a list to the parties with at least three candidates, in order for the parties to number the arbitrators in their order of preference or to reject them. Such system is commonly used in arbitration: An example of this is contained in the ICDR Arbitration rules.

When making the list of candidates who will be able to conduct the arbitration suitably, the court is to consult with one or several arbitration institutions, chambers of commerce or of industry on the appropriate candidates to serve as arbitrators in a given dispute. Moreover, the court has a discretionary power to appoint the arbitrator or arbitrators if, conforming to the lists system, it is not possible to appoint an arbitrator.

### B. Costa Rica

With the adoption of the Law 17.593 on international arbitration, Costa Rica has now joined the group of arbitration-friendly jurisdictions. Costa Rica's new arbitration law is largely based on the UNICTRAL Model Law, and the few differences that it has with the Model Law do not contravene the fundamental underlying principles of UNCITRAL's Model Law. However, there are some aspects and modifications that are worth mentioning.

#### 1. Scope of the Costa Rican Law

The Legislative Assembly decided to limit the scope of the law to only international arbitrations where the seat of arbitration is Costa Rica, whereas domestic arbitrations are still governed by other legislation, which may not reflect the principles underlying the Model Law.

#### 2. Form of the Arbitration Agreement

The new law does require that all arbitration agreements be in writing. However, this requirement can be fulfilled in the flexible manner intended under Article 7 of the Model Law which provides that an arbitration agreement will be in writing if its content is recorded in any form, including electronically. The agreement itself can have been reached orally or even by conduct.

#### 3. Number of Arbitrators

When the parties fail to determine the number of arbitrators, instead of adopting the default rule as established in the Model Law, the Legislative Assembly of Costa Rica changed the fallback rule to one arbitrator rather than three. Although parties are free to determine the number of arbitrators, Law 17.593 states that the number of arbitrators shall always be an odd number.

#### 4. Interim Measures

The current wording of Article 17 was adopted in 2006 by UNCITRAL (one of the main amendments in the Model Law) and it sets forth the possibility of granting interim measures "whether in the form of an award or in another form." In Law 17.593, this amendment to the Model Law was not followed. Instead, while not requiring interim measures to be granted in the form of awards, Law 17.593 does require that all interim measures be "reasoned. " It remains to be seen how arbitral tribunals will deal with this requirement. In any event, Law 17.593

does not impose a strict requirement of form (such as an award, order or a resolution) on the arbitral tribunal.

#### 5. Arbitrability

In regard to the matters subject to arbitration, the Model Law does not include a provision regarding arbitrability, a topic that is left for national laws to decide. In Law 17.593, Costa Rica's Legislative Assembly seized the opportunity to state that, under the laws of Costa Rica, individuals may submit to international commercial arbitration only matters on which, based on Costa Rica's commercial and civil legislation, individuals are free to agree.

#### 6. Nationality of Arbitrators

In connection with the nationality of arbitrators, experts and lawyers, the first draft of the new law that was discussed before the Legislative Assembly included a requirement for foreign practitioners to seek accreditation of their legal qualifications with the Costa Rican Bar authorities before being permitted to act in international arbitration proceedings where Costa Rica is the seat. While this was intended to be a "one time registration," this requirement would nonetheless have caused practical difficulties and would have resulted in a handicap to the parties when deciding on the possible candidates to act as arbitrators, lawyers or experts in international arbitrations seating in Costa Rica. Therefore, after consultations, the legislature agreed to remove such a requirement, and the decision has been very well received both in the local and international arbitration community.

Conclusively, the intention of the Legislative Assembly in adopting a law on arbitration based on the Model Law was to improve the legal framework in Costa Rica and to try to encourage selection of Costa Rica as a seat for international arbitrations. The Model Law is internationally recognized, and with Law 17.593 following it so closely, practitioners and arbitration users from all over the world will, hopefully, feel instantly at home under the new legislation. If, as is hoped, the Costa Rican courts also apply the new law in the way the international arbitration community expects, then Costa Rica could become a new, attractive spot on the "arbitration world map."

### C. Honduras

In July 2011, Honduras's new Law on the Promotion and Protection of Investment was published. The law recognizes arbitration as a means of dispute resolution and guarantees to investors the recognition of international arbitral awards rendered in accordance with the New York Convention,[2] the Panama Convention[3] and the ICSID Rules.

Further, it provides that, when mediation and conciliation between the investors and the state has failed, the parties may resort to arbitration as a means of dispute resolution. In this sense, the dispute shall be solved under the ICSID arbitration rules or, if the investors' country is not a party to the ICSID convention, under ICSID's additional facility. Similarly, if the parties so desire, their dispute may be solved before any of the local arbitration institutions. It is important to highlight that, under this law, the parties may not choose to subject their dispute to any international arbitration institution, but only to Honduran arbitral institutions.

### D. Ecuador

The 2008 Ecuadorian Constitution introduced significant changes to its arbitration regime. Even though Ecuador has not adopted the UNCITRAL Model Law, some positive steps have been taken regarding the arbitration framework. In this sense, the new Constitution recognized arbitration as a legitimate means for dispute resolution, thereby giving a constitutional status to arbitration. According to the above-mentioned amendment, arbitration and mediation may only be used in cases where it is possible to compromise or in public procurement upon a favorable opinion from the Attorney General of the relevant state pursuant to the conditions set forth in the applicable law.

However, the reform has a downside. The Ecuadorian constitution also introduced Article 422, which prevents Ecuador from entering into any treaty that provides for international arbitration to settle commercial disputes between the Ecuadorian government and private entities. However, international treaties and instruments providing for dispute resolution between states and citizens of Latin America by regional arbitral venues or by jurisdictional organizations designated by the signatory countries are excused from the foregoing. In the case of disputes relating to foreign debt, the Ecuadorean State shall promote arbitral solutions, subject to principles of transparency, equity and international justice.

However, since the true meaning and scope of Article 422 is still uncertain, it will be necessary to observe closely the Constitutional Court decisions on Ecuador's arbitration regime in order to better understand its effects, particularly regarding the validity of arbitration clauses in commercial contracts to which Ecuadorian public entities are parties.

## III. Recent Trends in Latin America Regarding International Arbitration

### A. Adoption of the Model Law and Modifications

Even though in the past two decades the number of Latin American countries that have adopted the Model Law has significantly increased,[4] several of these countries have made noteworthy changes to the Model Law when they incorporated it into their local arbitration framework. Often, when local legislators include a modification to the Model Law when adopting it, they do more harm than good to the international arbitral practice.

When model laws are made, time and effort is put into its elaboration. In this sense, when elaborating a model law, UNCITRAL summons experts from all around the world in order for them to give their input in the elaboration of a given model law and to be certain that the model law in question will not have provisions which are contrary to the national laws. Such was the case of the Model Law on International Commercial Arbitration. Just to give an idea, just the discussion on the modification of the Model Law regarding the arbitration agreement and interim measures took approximately six years.

In light of the above, a modification to a model law is a sensitive issue, since it will significantly alter the uniformity of the international regulation of that matter. In this vein, before making a modification to a model law, local legislators should bear in mind all the work that is behind its elaboration and should consider whether making such modification is absolutely necessary.

### B. Creation and Strengthening of Local Arbitral Institutions

#### 1. Center of Arbitration and Conciliation of the Bogotá Chamber of Commerce

The Bogota Chamber of Commerce was the first entity in Colombia that responded to the need for developing alternative methods of dispute resolution (ADR) by creating the Center of Arbitration and Conciliation in 1983. Since then, the Center has been a great promoter in Colombia and throughout Latin America of the application of ADR.

Over the past years, the Center of Arbitration and Conciliation of the Bogotá Chamber of Commerce has had significant growth. An example of this is the release of the "e-arbitration" system, which is a technological tool, through which the parties, attorneys, arbitrators and administrative secretaries of the arbitral tribunal are able to follow an arbitral process through the Internet. Through this tool, the parties are able to file any document through the Internet and have access to the "official" file from anywhere in the world.

#### 2. Arbitration Center of the Lima Chamber of Commerce

The Arbitration Center of the Lima Chamber of Commerce (CCL) was founded in 1993 and is the institution with the greatest experience in the administration of arbitrations in Peru. From 1993 to 2011 the Center has received, 2043 requests for arbitration and, according to the statistics, this number will continue increasing.

The Center also has a system which allows the parties and arbitral tribunals to follow the course of the arbitration and access the "official" file through the internet.

#### 3. Center of Arbitration and Mediation of the National Chamber of Commerce in Mexico City

Another example of an arbitral institution that has grown in the past years and has promoted new ways in which arbitration may be used is the Center of Arbitration and Mediation of the National Chamber of Commerce in Mexico City ("CANACO"). Recently, the CANACO implemented the ABC Arbitration,[5] which is intended for low cost disputes. Parties may access CANACO's ABC arbitration if the total amount of their dispute is less than approximately US$45,500. Given that it is an example of fast track arbitration, the ABC Rules establish that the arbitral award is to be rendered the next day after the hearing.

### C. Sophistication of the Arbitral Practice

#### 1. Experience of Counsel and Arbitrators

For several years, it was common to see highly experienced court litigation lawyers trying their luck in arbitration proceedings. As a consequence, many of the usages and practices applied in court litigation were being transferred to arbitration. Therefore, the arbitral process was losing several of its features as it was being implemented almost as a form of court litigation. For example, one of the features of arbitration that was not being utilized was the opportunity to use dispute strategies that may not be used in court litigation, such as "free" witness interrogatories. In arbitration, as opposed to many Latin American judicial procedures, witness interrogatories are not subject to formal rules and practices; therefore, interrogatories in arbitration are far more flexible and allow lawyers to use different techniques during interrogation, whereas in court litigation, lawyers are bound to follow the rules established for witness interrogatories, which often hinder the process.

Further, since arbitration was still in its first stages, the arbitrators chosen were usually lawyers that had never sat in the judge or arbitrator chair before. Therefore, since they were not used to seeing the dispute from an armchair, it was fairly easy for them to lose control of the proceedings. Furthermore, the conferences and forums, where highly experienced practitioners gave lectures regarding the arbitrator's role and the parties' expectations from their arbitrators, were held. Nowadays, these forums are common, which allow new arbitrators to learn more about their role, rather than learning it during the course of the proceedings.

#### 2. The Latin American Arbitration Association

Another example of the sophistication of the arbitral practice in Latin America is the creation of the Latin American Arbitration Association. The Association's main objectives are, among others, (i) the dissemination of international arbitration in Latin America as a means

for resolving disputes, (ii) giving assistance to arbitral institutions, (iii) the analysis and practical study of problems concerning the functioning and effectiveness of international arbitration in the region, and (iv) the implementation of initiatives to improve and modernize the legal framework of arbitration in the different countries of Latin America.

Certainly, with the creation of this kind of association the arbitral practice will continue becoming more sophisticated. That will result in a benefit for parties that choose arbitration as the means to solve their disputes.

### D. Trends in Right to "Exchange of Documents"

In several Latin American countries, to have access to documents that are in the possession of the other party, under the procedural rules applicable to court litigation, is almost impossible. On the other hand, in arbitration the latter is a common practice between the parties.[6] In international arbitration, the request for documents constitutes an integral part of a party's opportunity to prove its case. However, when the exchange of documents is not handled properly, the costs of the arbitration may drastically increase. For this reason, the IBA Rules on the Taking of Evidence in International Arbitration ("IBA Rules") establish that the entire evidentiary process will be conducted under the principle of good faith, and if a party fails to conduct the exchange in good faith, such a violation may be penalized. To base the exchange of documents in good faith will result in both not requesting documents which the requesting party does not need and not producing an excessive amount of documents in order to lose the requesting party in a truck full of irrelevant documents.

In this context, the North American trend is to limit the scope of the production of documents in order to avoid an unnecessary increase in the arbitration costs and to serve the arbitral process well by avoiding needless complications.

On the other hand, in Latin America the exchange of documents is becoming more accepted and the tendency is to implement it. The latter is not necessarily in contradiction with the North American tendency: It is only a different scenario. In Latin America, document production has been a very useful tool that was not previously available, since the majority of the procedural court rules in Latin American countries did not allow its implementation. Therefore, counsel and arbitrators alike are increasingly becoming more acquainted with the practice of requesting documents and allowing such requests. Nonetheless, parties and counsel, regardless of where are they from, should always keep in mind the costs of the arbitration when requesting and producing documents.

## IV. Conclusion

After analyzing the several trends of arbitration in Latin America, it is beyond question that arbitration is increasingly becoming a more suitable option for dispute resolution in Latin America. Because so many countries have adopted the model law, arbitral laws are being homogenized, offering the parties certainty and assurance when choosing a Latin American country as the seat of their arbitration.

Finally, the efforts made to encourage arbitration are not only the product of the work made by the legislature of the different countries, but also are the product of the work of the arbitral institutions that administer arbitration and of the practitioners that keep seeking to be more prepared.

## Endnotes

1. 1985 UNCITRAL Model Law on International Commercial Arbitration.
2. United Nations Convention on the Enforcement and Recognition of Foreign Arbitral Awards, 1958.
3. Inter-American Convention on International Commercial Arbitration, 1975.
4. The most recent countries that have adopted the Model Law in Latin America are: Mexico (1993), Guatemala (1995), Peru (1996, adopted the 2006 amendments in 2008), Venezuela (1998), Honduras (2000), Paraguay (2002), Chile (2004), Nicaragua (2005), Dominican Republic (2008) and Costa Rica (2011, adopting the 2006 amendments).
5. In Spanish*: Arbitraje de Baja Cuantía.*
6. Very often such practice is governed by the IBA Rules on the Taking of Evidence in International Arbitration.

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# The Multinational Employer in the Age of the Whistleblower

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## I. Introduction

With the rise of the global workplace come concerns for multinational employers. Indeed, one of the most critical legal issues for any multinational employer is the degree to which U.S. law applies in foreign offices. Although the extraterritorial application of certain U.S. employment laws was fairly uncertain for some time, Congress and the courts have resolved many of the legal ambiguities. Nevertheless, uncertainties continue to arise with the passage of new statutes and the nuance of changing circumstances.

The U.S. Supreme Court has held that there is a presumption against the extraterritorial application of federal employment statutes, absent an express provision in the statute or other indication from Congress.[1] This strong presumption against extraterritoriality serves at least two public policy purposes: (1) to protect against "unintended clashes between our laws and those of other nations which could result in international discord" and (2) to uphold the principle that when Congress legislates it "is primarily concerned with domestic conditions."[2] In this vein, Congress and/or courts have determined that many labor and employment statutes do not apply extraterritorially (or have carefully circumscribed their extraterritorial reach).[3]

A topical issue, the Supreme Court strongly affirmed the presumption against extraterritoriality as recently as 2010 in *Morrison v. National Australia Bank Ltd.*,[4] holding that Section 10(b) of the Securities Exchange Act ("SEA") and Securities Exchange Commission ("SEC") Rule 10b-5 do not apply to securities transactions that take place outside the United States.[5] The SEA's general silence as to its extraterritorial application[6] prompted federal district courts in the Second Circuit and the Second Circuit itself to apply the so-called "conduct" or "effects" tests, discussed below, to transnational frauds under Section 10(b) in order to determine the scope of its territorial bounds. In overturning decades of case law, the Supreme Court concluded that "the Second Circuit never put forward a textual or even extratextual basis for these tests."[7] Dismissing the tests as "not easy to administer," "vague formulations," and "unpredictable and inconsistent," the Supreme Court found that a history of criticism was "justified."[8]

Given the recent interest in and jurisprudence on extraterritoriality (particularly with respect to employment law), this article examines the still uncertain nexus of extraterritoriality and an ever-growing niche of employment law: whistleblowing. Indeed, in the United States (and elsewhere) a number of recently enacted or proposed federal employment laws contain expansive employee whistleblowing protections. Given this trend, this article examines and analyzes the foreign applicability of the whistleblowing provisions of laws that either target or affect the multinational corporation, including the United States' Sarbanes-Oxley Act of 2002 ("SOX") and the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank"), as well as the United Kingdom's Bribery Act of 2010.

## II. Sarbanes-Oxley Act of 2002

Enacted in 2002, SOX provides protection against retaliation for an employee who reports what he or she reasonably believes to be fraudulent activity, including wire, mail, bank and securities fraud, as well as violations of SEC Rules and other federal laws relating to fraud against shareholders. At base, under SOX, an employer may not discharge or otherwise retaliate against an employee because that employee provided information or assisted in an investigation of fraudulent activity (whether the investigation is done internally or by a governmental agency). Part I of this article reviews U.S. and foreign case law and rules regarding the extraterritorial application of SOX's main whistleblowing provisions.

### A. SOX Section 806

Section 806 of SOX protects employees of companies subject to the SEA who lawfully cooperate with an investigation concerning its violation. Though other SOX provisions enjoy extraterritorial application, the majority view of U.S. courts is that the whistleblowing protections of Section 806 do not apply overseas.[9] In *Carnero v. Boston Scientific Corp.*, a seminal case, the plaintiff argued to no avail that "to limit the operation of the statute to purely domestic conduct in the United States would improperly insulate the foreign operations of covered companies," and ultimately "frustrate the basic purpose of the Sarbanes Oxley Act…to protect both the investors in the U.S. securities markets and the integrity of those markets."[10]

Despite recognizing the plaintiff's "argument ha[d] some force," the First Circuit determined that the absence of clear congressional intent is an "*insurmountable hurdle* in the well-established presumption against the extraterritorial application of Congressional statutes."[11] In contrast to the silence of Section 806, the First Circuit stressed that "Congress has provided expressly elsewhere in the Sarbanes Oxley Act for extraterritorial enforcement of a different, criminal whistleblower statute."[12] Furthermore, SOX "provided expressly for the extraterritorial appli-

cation of certain other unrelated statutes."[13] The First Circuit concluded that such evidence proved "Congress demonstrated that it was well able to call for extraterritorial application when it so desired."[14]

As a minority voice, the Southern District of New York challenged (perhaps unwittingly) the well-accepted holding of *Carnero* by endorsing the application of Section 806 to employees working overseas, so long as the alleged wrongful conduct holds a significant nexus to the United States. In *O'Mahony v. Accenture Ltd.*,[15] a self-recognized "point of departure," the Southern District sought to distinguish the factual circumstances of its case from *Carnero*, which it argued "offer[ed] limited guidance to the Court."[16] Relying on now-overruled Second Circuit case law, the Southern District formulated that, when a court "is confronted with transactions that on any view are predominantly foreign, it must seek to determine whether Congress would have wished the precious resources of United States courts and law enforcement agencies to be devoted to them rather than [to] leave the problem to foreign countries."[17] Summarizing the *Morrison*-overruled approach of the Second Circuit to issues of extraterritoriality, the court considered (or would have considered) (1) whether the wrongful conduct occurred in the United States (the "conduct test"), and (2) whether the wrongful conduct had a substantial adverse effect in the United States or upon United States citizens (the "effects test").[18] Given *Morrison*'s affirmation of the doctrine of "expressed intent" and disdain for the Second Circuit's formulation and application of the conduct and effects tests, *O'Mahony*, although not directly overruled, is a marginalized outlier.

### B. SOX Hotline Mandate

Section 301 affirmatively encourages whistleblowing with a "hotline mandate," so to speak, requiring SOX-regulated companies to institute "procedures" for handling "confidential, anonymous" "employe[e]" "concerns" over possible corporate misdeeds, as provided below:

> Each audit committee shall establish procedures for: (A) the receipt, retention, and treatment of complaints received by the issuer regarding accounting, internal accounting controls, or auditing matters; and (B) the confidential, anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters.[19]

Little case law addresses the extraterritorial application of Section 301, but one can speculate as to the potential of such application. Section 301 applies to "issuers," some of which are based in the U.S. with extensive employment operations abroad. Accordingly, it is widely assumed that the Section 301 hotline mandate applies abroad and must be made available to overseas employees of U.S. and non-U.S. companies. The SEC considers SOX as reaching foreign private issuers and has even extended their date for SOX compliance.[20]

In promulgating rules under this section, the SEC implied that Section 301 applies to U.S.-based multinationals' overseas employees:

> The [reporting/hotline] procedures that will be most effective to meet the requirements for a very small listed issuer with few employees could be very different from the processes and systems that would need to be in place for large, *multinational corporations with thousands of employees in many different jurisdictions*.[21]

The SEC's assumption that Section 301 applies abroad is certainly debatable. Nowhere in the text of Section 301 does it state that the statute reaches overseas employees. This silence, coupled with the presumption against extraterritoriality, could lead to a contrary result as discussed above.

Indeed, the First Circuit held in *Carnero* that Section 301, like Section 806, is silent on its extraterritorial reach, meaning that the *Carnero* analysis could well apply to Section 301 (*i.e.*, Section 301 would not mandate SOX hotlines overseas). However, many multinationals note that Section 301 differs from Section 806 in that the mandate of Section 301 to establish employee hotlines is less related to employment law than the prohibition of retaliation in Section 806. *Carnero* itself notes that Section 301 "does not…purport to confer enforceable rights upon employees, hence does not implicate the foreign sovereignty and other concerns [of Section] 806.…" Nevertheless, conflicts surely have arisen (and will continue to arise) for SOX-regulated multinationals seeking to comply with SOX and local laws.

### C. Applicability of European Labor Laws to SOX Hotlines

In Northern Continental Europe (except Scandinavia), workers organize themselves not only into trade unions, but also into "works councils," or in-house employee representative groups, with whom management "informs" and "consults" (bargains) on workplace issues. European employers have a duty analogous to a U.S. "mandatory subject of bargaining" to tell works council representatives about proposed changes to the workplace, and to consult with them in good faith regarding their opinions to such changes. Launching a new rule or policy such as a denunciation (whistleblowing) hotline falls under this duty, if the rule materially changes work conditions. Given the social taboo over denunciations, a Northern Continental European worker will see as "material" any rule that forces him to report on his fellows or subjects him to a system by which his fellows can anonymously denounce him. The case law is instructive.

In *Wal-Mart, Beschluss des Arbeitsgerichts Wuppertal*,[22] a German labor court invoked works council law to strike down Wal-Mart's SOX hotline. Wal-Mart's policy (like most U.S. multinationals' policies) stated that an employee could be fired for not taking action; that is, it imposed an affirmative duty to blow the whistle on coworker fraud. Further, the policy (like many U.S. multinationals' policies) went well beyond SOX by requiring reports of wrongdoing not only for audit and accounting fraud, but also for non-SOX violations like theft and harassment. The German court thus held that Wal-Mart had violated Section 87 1(1) of the German Works Constitution Act by implementing its denunciation rule and hotline in Germany, via headquarters mandate, without first "co-determining" (i.e., consulting) with the German works council. Though Wal-Mart is an Arkansas-based multinational that implemented a global policy (at least in core part mandated by a U.S. federal law), the German labor court held the global policy context did not excuse Wal-Mart's local German subsidiary from its bargaining obligations. The *Wal-Mart* decision does not rule hotlines or policies to be illegal; rather it merely requires bargaining over them.

### D. Application of European Data Privacy Law to SOX Hotlines

All European Union states have adopted ("transposed") into their national laws the EU Data Protection Directive,[23] a privacy law that imposes rules completely unlike the data-privacy-law mandates of the U.S. These laws reach all sorts of business recordkeeping, including human resources personnel files. One specific interpretation of EU data law reaches whistleblower hotlines. France has been the EU member state championing this interpretation.

In May 2005, the French data protection bureaucracy, the *Commission nationale de l'informatique et des libertés* (referred to as "CNIL"), refused to grant two SOX-regulated U.S. multinationals, McDonald's and CEAC Technologies, permission to run whistleblower hotlines in France, because their proposed denunciation systems violated France's data protection law.[24] The CNIL ruled that proposed U.S.-style anonymous hotlines of McDonald's and CEAC Technologies would threaten privacy rights of those denounced in that the hotline and could deprive these employees of their right to be told of the denunciations against them and of a procedure to prove their innocence.

In September 2005, a French court—the *Tribunal de Grande Instance de Libourne*—decided a very similar case the same way.[25] This case rested on general French employment law and due process principles—not specifically on the data privacy law. The court held that a former unit of Owens-Illinois violated French law when it rolled out a SOX hotline in France (GlassPack's hotline had been implemented directly as a SOX measure). The court found the hotline "disproportionate" because it allowed anonymous whistleblowing on "fraud or theft," and thereby endangered the "individual liberties" of potential whistleblowing targets.

On 10 November 2005, the CNIL issued guidelines to assist companies in developing SOX- and French law-complaint whistleblower programs.[26] On 8 December 2005, the CNIL issued a completely separate set of SOX-hotline guidelines under its declaration procedure. These December guidelines allow employers to launch a SOX hotline in France without awaiting cumbersome CNIL authorization.

Accordingly, whistleblower programs may be authorized by either: (1) self-certification to the CNIL, through an automated online system, that the whistleblower program complies with specific requirements (the "AU-004 authorization"); or (2) CNIL's formal approval, which involves a longer review process and frequently company document submissions. Under the 2005 guidelines, to satisfy the requirements for the online AU-004 authorization, the whistleblower program in France had to be restricted to accounting, finance, banking or corruption matters, with other "vital interests" of the company or its employees' physical or mental integrity also admissible for hotline intake (so long as then transferred to the appropriate department, such as Human Resources).

In December 2009, the French Supreme Court decided that the AU-004 authorization should be restricted to whistleblower programs that exclude other "vital interests" matters. In response to the decision, in late 2010 the CNIL set forth revised guidance for the AU-004 authorization. Companies must now limit the whistleblower program to accounting, financial, banking, anti-competition or corruption matters. Matters regarding "vital interests" of the company or its employees' physical or mental integrity can no longer receive online AU-004 authorization. Such concerns may still be reported though regular channels that are distinct from the hotline and outside the CNIL's rules, including supervisors or managers.

Globally speaking, each EU member state's data statute differs, and each data protection bureaucracy has every bit as much power as France's CNIL to offer its own interpretations. Whatever each country's interpretation, it must be taken into account when crafting a SOX whistleblower hotline in that country before that hotline is implemented.

As guidance, on 1 February 2006, the EU's "Article 29 Data Protection Working Party," an advisory EU-level body charged with advising on EU data protection law, issued an 18-page "Opinion 1/2006 on the application of EU data protection rules to internal whistleblowing schemes in the field of accounting, internal accounting controls, auditing matters, fight against bribery, banking and financial crime."[27] This opinion essentially ratifies the CNIL's interpretation of data law: without taking quite as hard-line a position as the CNIL, the Article 29 Work-

ing Party opinion addresses (a) "protection of the person incriminated through a whistleblowing scheme" (Section III); (b) "assessment of the compatibility of whistleblowing schemes with data protection rules" (Section IV); (c) "provision of clear and complete information about the scheme" (Section IV(3)); (d) "rights of the incriminated person" (Section IV(4)); (e) "security of processing operations" (Section IV(5)); (f) "management of whistleblowing schemes" (Section IV(6)); (g) "transfers to third countries" (Section IV(7)); and (h) "compliance with notification requirement" (Section IV(8)). Article 29 is not binding; but many European states will likely follow it.

## III. Dodd-Frank

In the aftermath of the global economic meltdown, the U.S. Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"), an overhaul of the financial regulatory system not seen since the Great Depression. While a number of Dodd-Frank's provisions have received legal scrutiny and public fanfare, the Act also contains lesser-known whistleblower provisions that provide expansive protections to covered employees. These whistleblower provisions include Sections 922 and 748, which create new private rights of action for whistleblowers under the SEA and the Commodity Exchange Act ("CEA"), respectively, and Section 1057, which creates a new private right of action for whistleblowers in the financial services industry. Dodd-Frank also expands the whistleblower protections of SOX and the False Claims Act.

Given the recent passage of Dodd-Frank and the dearth of litigation concerning its application, the extraterritorial reach of its three main whistleblowing provisions—Sections 922, 748, and 1057—has prompted interest and debate. Despite the global dimension of the economic collapse to which Dodd-Frank responded and that many corporations subject to the Act's purview have a multinational presence, none of the whistleblowing provisions expressly states that its protections apply overseas, which creates a strong presumption against extraterritoriality, as recently affirmed by the Supreme Court in overruling the Second Circuit. Based on these established legal standards, Part III determines that Dodd-Frank's main whistleblowing provisions will likely not extend abroad.

### A. Section 922

Section 922 amends the SEA to prohibit retaliation against whistleblowers for (1) providing statutorily defined information to the SEC, (2) assisting in any investigation or judicial or administrative action of the SEC based upon or related to such information, or (3) making disclosures that are required or protected under the SEA or SOX. An action under Section 922 may not be brought more than six years after the date on which the violation occurred, or, under the so-called "discovery rule," more than three years after the date when facts material to the right of action are known or reasonably should have been known by the whistleblower alleging the violation. If the whistleblower suffers discrimination, relief includes (1) reinstatement with the same seniority status that the individual would have had, but for the discrimination; (2) two times the amount of backpay otherwise owed to the individual, with interest; and (3) compensation and litigation cost, expert witness fees, and reasonable attorney's fees. Whistleblowers may also receive monetary rewards directly from the SEC, on which the SEC expounded when it issued final rules in May 2011.[28]

Section 922 does not explicitly mention extraterritorial application, and therefore, a presumption against such application exists.[29] As noted above, protected activity under Section 922 implicates other sections of Dodd-Frank and securities laws administered or enforced by the SEC, which may or may not enjoy extraterritorial application in their own right. Nevertheless, as also noted earlier, it is unlikely that a court will necessarily find that Section 922 applies extraterritorially if the underlying statutory violation that is reported receives such application. Assuming *arguendo* such an unlikelihood transpires, it is still a matter of controversy whether, for instance, Section 929P(b) of Dodd-Frank even overturned *Morrison* to provide for extraterritorial application in anti-fraud actions brought by the SEC or the Department of Justice.

From the plain wording of Section 929P(b), Dodd-Frank extends the *jurisdiction* of U.S. district courts to hear cases where the SEC intends to enforce the antifraud provisions of the Securities Act of 1933, the SEA and the Investment Advisers Act of 1940 concerning transactions that occurred outside the United States, as long as (1) the conduct within the United States constitutes significant steps in furtherance of the violation (even if the securities transaction occurs outside the United States and involves only foreign investors); or (2) the conduct occurring outside of the United States has a foreseeable substantial effect within the United States. This wording is critical, for *Morrison* expressly held that the extraterritorial scope of Section 10(b) is not a "question of subject matter *jurisdiction*," but a "merits question."[30]

In other words, on its face, Section 929P(b) only speaks to jurisdiction and, under the holding of *Morrison*, likely does nothing to enlarge the territorial turf of the government's anti-fraud *enforcement* powers. That is not to say that no court will disagree, but *Morrison* was especially clear to reaffirm "the wisdom of the presumption against extraterritoriality," stating, "Rather than guess anew in each case, we apply the presumption in all cases, preserving a stable background against which Congress can legislate with predictable effects."[31] With the use of the word "jurisdiction" in Section 929P(b), courts will likely hesitate to imply extraterritorial application of the anti-fraud provisions.

According to the SEC, however, "With respect to U.S. Government and Commission actions, the Dodd-Frank Act largely codified the long-standing appellate court interpretation of the law that had existed prior to the Supreme Court's decision in *Morrison* by setting forth an expansive conducts and effects test, and providing that the inquiry is one of subject matter jurisdiction. The Dodd-Frank Act made similar changes to the Securities Act of 1933 and the Investment Advisers Act of 1940."[32] Despite the SEC's non-binding commentary and the confident assertion by one of the authors of Dodd-Frank that Section 929P(b) "make[s] clear that in actions and proceedings brought by the SEC or the Justice Department…provisions of the Securities Act, the Exchange Act, and the Investment Advisers Act may have extraterritorial application,"[33] the text of the section does not disturb and, in fact, furthers the holding of *Morrison*.

Finally, Dodd-Frank expressly recognizes that whether extraterritorial application extends to certain securities laws was indeed not decided by the Act. For example, according to Section 929Y of Dodd-Frank, the SEC will solicit public comment and thereafter conduct a *study* to determine the extent to which *private rights of action* under the antifraud provisions of the SEA should extend to (1) conduct within the United States that constitutes a significant step in the furtherance of the violation, even if the securities transaction occurs outside the United States and involves only foreign investors; and (2) conduct occurring outside the United States that has a foreseeable substantial effect within the United States. But until such a study becomes law, the extraterritorial application of at least one of the main provisions of the SEA (concerning private actions) remains limited by *Morrison*. And, in light of the *Morrison* decision, courts will be wary to apply the "conduct" or "effects" tests to Section 922 protected activity. Furthermore, as noted earlier, even if the underlying conduct that the whistleblower has reported is subject to extraterritorial application, it does not follow that a court will also extend the geographical reach of the whistleblowing protections *themselves* (which even *O'Mahony* did not allege).

### 1. Foreign Corrupt Practices Act

While the whistleblower bounty exists for all securities violations, the risk that companies face is particularly great relative to the Foreign Corrupt Practices Act ("FCPA"), which broadly proscribes corruptly influencing foreign public officials. The remarkable monetary sanctions in FCPA enforcement actions, where SEC settlements in the tens or even hundreds of millions of dollars have become increasingly common,[34] provide a compelling incentive for individuals to contact the SEC about suspected FCPA violations. Subject to certain limited exceptions,[35] a whistleblower can be "any individual"—companies thus face potential exposure from both corporate insiders (including any officer, director, employee, or shareholder of the parent company and any of its subsidiaries), as well as anyone with whom it does business and, as a result, might learn about a violation (whether a business competitor, any employee of any agent, consultant, distributor, vendor, outside contractor, service provider, or customer of the company, or otherwise). Section 240.21F-4 of the SEC's final whistleblower rules does, however, restrict corporate insiders from award eligibility if information is obtained through company investigations or certain other processes, with exceptions.

The dramatic increase in FCPA enforcement efforts,[36] along with the comprehensive press coverage surrounding such efforts and the expected cottage industry of lawyers and others, will ensure that potential whistleblowers are aware of, and take full advantage of, this enticing incentive.

This increased risk underscores the importance for companies to consider self-reporting FCPA violations. Previously, certain companies may have taken the calculated risk of remediating, but not self-reporting, in the hope that the problem caused by rogue employees in some far corner of the world could be corrected. Those companies planned that the conduct would not otherwise see the light of day, thereby avoiding the steep costs of defending an external investigation and any penalties that may be imposed. Such a strategy now is riskier. Companies should be cautious to not rely on the "silence" of those who have learned about the problem. By creating generous incentives for potential whistleblowers, some of the hoped-for benefit of not self-reporting may have been diminished. In light of Dodd-Frank, companies may want to reconsider self-reporting and the benefits that it typically offers (including, possibly, a smaller monetary sanction).

The increased possibility that FCPA violators will face substantial sanctions for violations that may have been "under the radar" previously also suggests that companies have even greater reason to inhibit bribery and fraud from occurring in the first place. The importance of effective internal controls and compliance programs to detect and prevent FCPA and other securities violations has intensified. With the new bounty, companies will need to adapt to this defining change in the legal landscape.

## B. Section 748

Section 748 amends the CEA to prohibit retaliation against whistleblowers for (1) providing statutorily defined information to the Commodity Futures Trading Commission ("CFTC"), or (2) assisting in any investigation or judicial or administrative action of the Commission based upon or related to such information. Under Section 748 an action may not be brought more than two years after the date on which the violation is committed. Section 748 provides the same forms of relief and incentives for whistleblowers available under Section 922. On 4 August 2011, the CFTC adopted final rules regarding the whistleblowers incentive program under Section 748.

Section 748 also does not explicitly provide for extraterritorial application. As with Section 922, other provisions of Dodd-Frank that implicate Section 748 address extraterritorial applicability. For instance, Section 722 of the Dodd-Frank Act sets forth that the application of the CEA for swaps that were enacted by the Wall Street Transparency and Accountability Act of 2010 ("WSTAA") (including any rule prescribed or regulation promulgated under the Act), shall not apply to activities outside of the United States unless those activities (1) have a direct and significant connection with activities in, or effect on, commerce of the United States; or (2) contravene such rules or regulations as the Commission may prescribe or promulgate as are necessary or appropriate to prevent the evasion of any provision of this Act that was enacted by the WSTAA.

Notably, in Section 722, the "jurisdictional" language from Section 929P(b) is missing. Nevertheless, in most other instances, the CEA is silent as to extraterritorial application,[37] and Second Circuit courts have previously applied the "conduct" or "effects" tests to the CEA in a way that is similar to the SEA's *rejected* application.[38] Therefore, in the instances where Section 748 violations are "foreign," courts will probably not extend the application of the section overseas.

### C. Section 1057

Section 1057 creates a new whistleblowing provision that covers financial services employers, which the section defines with great specificity. It prohibits retaliation where the whistleblower (1) provided (or is about to provide or cause to be provided) information to the employer, the Bureau of Consumer Financial Protection ("Bureau"), or any other government authority or law enforcement agency relating to any violation (or the employee's reasonable belief of a violation) of Dodd-Frank's financial consumer protection provisions, as well as any other provision of the law that is subject to the jurisdiction of the Bureau; (2) testified (or will testify) in any proceeding resulting from the administration or enforcement of any provision of Dodd-Frank's financial consumer protection provisions, as well as any other provision of the law subject to the jurisdiction of the Bureau; (3) filed (or caused to be filed or instituted) any proceeding under any federal consumer financial law; or (4) objected to (or refused to participate in) any activity the employee reasonably believed to be in violation of any law subject to the jurisdiction of the Bureau.

An action pursuant to this section must be brought within one hundred eighty days from the date on which the violation occurred. Relief includes (1) affirmative action to abate the violation; (2) reinstating the complainant to his or her former position, together with compensation (including back pay) and restoring the terms, conditions, and privileges associated with his or her employment; and (3) providing compensatory damages to the complainant.

There is no expressed intent in Section 1057 of extraterritorial application, which creates a presumption against such jurisdiction. Furthermore, most of the consumer financial protections regulated by the Bureau, as well as the eighteen enumerated consumer laws defined as part of the "federal consumer financial law," primarily pertain to *domestic* issues. Indeed, a number of the enumerated consumer laws do not even address extraterritorial application. And because a foreign branch of a U.S. bank is not an entity located in the United States, some of the enumerated consumer laws (pursuant to their respective regulations) expressly exclude foreign branches of U.S. banks from coverage.

For instance, the regulations implementing the Consumer Leasing Act,[39] the Truth in Lending Acts,[40]and the Home Ownership Equity Protection Acts[41] expressly state that they do not apply to a foreign branch of a U.S. bank or to a leasing company leasing to a U.S. citizen residing or visiting abroad or to a foreign national abroad. In addition, the regulation implementing the Equal Credit Opportunity Act generally does not apply to lending activities that occur outside the United States.[42] According to the regulation of the Truth in Savings Act, accounts held in an institution located outside the United States are not covered, even if held by a U.S. resident.[43]

Not to say that reporting violations of enumerated financial consumer laws will any way qualify for extraterritorial protection, but a few of the laws suggest that their provisions may apply to conduct abroad (albeit in limited circumstances). For instance, the Federal Trade Commission Staff Commentary on the Fair Debt Collection Practices Act clarifies that a debt collector includes a party based in the United States who collects debts owed by consumers residing outside the United States.[44] The Official Staff Commentary implementing provisions of the Home Mortgage Disclosure Act indicates that branches of foreign banks may be covered by its provisions.[45] The Official Staff Commentary for the Electronic Fund Transfer Act explains that the Act applies to all persons (including branches and other offices of foreign banks located in the United States) that offer EFT services to residents of any state, including resident aliens. The Act, however, does not apply to a foreign branch of a U.S. bank unless the EFT services are offered in connection with an account in a state.[46]

## IV. U.K. Bribery Act

### A. Overview

By way of background, enacting a law against bribery of foreign officials is not in itself new or unique. As discussed earlier, in the U.S., such conduct is prohibited by the FCPA. In France, Article 435 of the Penal Code expressly criminalizes both giving and receiving (or offering and soliciting) such bribes. Other countries have similar statutes. The U.K. embarked on the recent overhaul of its century-old anti-bribery law primarily to bring its law up

to the international standards set out by the 32-nation Organization for Economic Co-operation and Development (OECD).

The recently effective U.K. Bribery Act of 2010 contains new, specific criminal offenses designed to prevent and punish the bribery of foreign public officials for the purpose of obtaining a competitive advantage in international trade—once again placing public corruption in the international spotlight. Also of significance is the prospect of whistleblowing liability for both domestic *and* foreign-based employers who take disciplinary action against employees for reporting violations of the Act.

### B. Whistleblowing Protections

Under U.K. law, workers and employees receive whistleblowing protections, so that they are not deterred from reporting wrongdoing. The Public Interest Disclosure Act of 1998 amended the Employment Rights Act (ERA) of 1996, which protects "workers" (broadly defined to include agency workers and homeworkers as well as those attending training courses) from suffering detriment (section 47B) and "employees" from dismissal (section 103A) by reason of having made a protected disclosure.

Accordingly, to establish a whistleblowing claim under U.K. law, a worker must suffer detriment (or an employee must have been dismissed) by reason of (i) having made a disclosure of information, which is both (ii) qualifying and (iii) protected.

The disclosure must pertain to a "relevant failure"—a very broad standard that could conceivably relate to any legal obligation. For example, section 43B of the ERA references a failure to "*comply with any legal obligation*." Indeed, in *Parkins v Sodexho*,[47] a breach of the employee's own employment contract fell within scope of a relevant failure—albeit not a matter of public interest (despite the name of the underlying legislation).

There must also be a "reasonable belief" that the information disclosed shows a relevant failure. In particular, there must be some evidence in support of disclosure, and the belief must be based on more than an unsubstantiated rumor (*i.e.*, the quality and quantity of information available in support of allegation). It is not fatal if that belief is wrong or if it is proven that the facts alleged do not amount to a relevant failure.

As for the Bribery Act in particular, HR practitioners already need to be aware of several important aspects of the new U.K. regime, including the introduction of a new defense to corporate liability for bribery committed by an employee or agent of behalf of the company. Under the new law, businesses can avoid liability for unlawful acts committed by their employees if they had in place "adequate procedures designed to prevent…such conduct."

On 30 March 2011, the U.K. Ministry of Justice published long-awaited Guidance on the implementation of "adequate procedures" under the Bribery Act. The guidance contains six principles, and importantly, includes express reference in Principles 1 and 2 to the need for adequate whistleblowing policies and procedures. In other words, the guidance articulates that having a whistleblowing regime in place—one that fosters a culture encouraging employees to report wrongdoing—is an integral part of defending against corporate bribery.

In addition, the substance of the guidelines means that a failure to have adequate whistleblowing procedures and policies could raise the inference of a breach of the guidelines, *even* where there is no express reference to whistleblowing.

Employers must carefully draft and implement such procedures to immunize themselves from liability. As part of this strategy, management must consider any emerging risks for bribery and corruption from within its corporate structure. As an ABC compliance program matures, it will inevitably bring to light certain areas or practices which bear improvement in subsequent versions of the program. In order to facilitate this discovery, companies must establish reliable methods for monitoring and reviewing the program and its results. This includes employers making available whistleblower mechanisms, both to in-house and to third-party employees. Such mechanisms may take the form of hotlines phone numbers, an e-mail system for reporting violations, etc.

### C. Extraterritorial Application

The Bribery Act has attracted significant attention for its breadth. In particular, it has express extraterritorial jurisdiction, which means bribery committed abroad by persons ordinarily resident in the U.K. as well as U.K. nationals and corporate bodies will become a criminal offense in the U.K. Furthermore, any company or organization with a U.K. "business presence" is subject to its jurisdiction, which may include foreign companies with very limited presence or operations in the U.K. Conceivably, therefore, the Act may apply in scenarios where the predicate bribery offense took place in a third country, involved non-U.K. nationals, and was unrelated to U.K. operations.

## V. Conclusion

Because there is a strong presumption against extraterritorial application where there is no clear congressional intent and given *Morrison*'s holding, U.S. courts will likely not find (or will continue not to find) that the whistleblowing provisions of SOX and Dodd-Frank apply overseas. As *Carnero* pointed out, it is especially unlikely that Congress intended extraterritorial application for a particular statutory provision when it expressly mentions

extraterritorial application in another statutory provision of the same Act (as both SOX and Dodd-Frank did). Nevertheless, to avoid lengthy litigation and steep penalties, it would behoove multinational corporations to prepare for the prospect that SOX's and Dodd-Frank's whistleblowing protections extend beyond the United States and take the appropriate internal measures. This is also the case with the U.K.'s Bribery Act, which too has the potential for expansive extraterritorial reach.

Simply put, with a multinational workforce comes international responsibility (and headache).

## Endnotes

1. *EEOC v. Arabian American Oil Co.*, 499 U.S. 244 (1991) (hereafter "*Aramco*"). In the wake of *Aramco*, Congress amended the staple of employment discrimination law, Title VII of the Civil Rights Act of 1964, to provide expressly for extraterritoriality, with other employment discrimination statutes codifying the same concept, including the Age Discrimination in Employment Act and the Americans with Disabilities Act.
2. *Aramco*, note 1 *supra*, 499 U.S. at 248.
3. Such statutes include the Fair Labor Standards Act, the Equal Pay Act, the Labor Management Relations Act, the Railway Labor Act, the Worker Adjustment and Retraining Notification Act, the Family and Medical Leave Act, and the Occupational Safety and Health Act, to name a few.
4. 130 S. Ct. 2869 (2010) (hereafter "*Morrison*").
5. The case law overturned by *Morrison* includes the following: *SEC v. Berger*, 322 F.3d 187, 194-195 (2d Cir. 2003); *Alfadda v. Fenn*, 935 F.2d 475 (2d Cir. 1991) (hereafter "*Alfadda*"); *IIT v. Cornfeld*, 619 F.2d 909 (2d Cir. 1980); *Leasco Data Processing Corp. v. Maxwell*, 468 F.2d 1326 (2d Cir. 1972).
6. *See, e.g., Alfadda*, note 5 *supra*, 935 F.2d at 478, *rev'd on other grounds*, *Morrison*, note 4 *supra*, 130 S. Ct. 2869.
7. *Morrison*, note 4 *supra*, 130 S. Ct. at 2879.
8. *Id.* at 2879-2881.
9. *See Carnero v. Boston Scientific Corp.*, 433 F.3d 1 (1st Cir. 2006) (hereafter "*Carnero*"); *Concone v. Capital One Financial Corp.*, No. 2005-SOX-00006, 2004 WL 3127233 (O.S.H.R.C.A.L.J. 3 Dec. 2004).
10. *Carnero*, note 9 *supra*, 433 F.3d at 7.
11. *Id.* (emphasis added).
12. *Id.*
13. *Id.*
14. *Id.*
15. 537 F. Supp. 2d 506 (S.D.N.Y. 2008).
16. *Id.* at 511.
17. *Id.* at 511-512 (quoting *SEC v. Berger*, 322 F.3d 187, 192 (2d Cir. 2003)).
18. *Id.* at 512 (citing *SEC v. Berger*, 322 F.3d 187, 192 (2d. Cir. 2003)). Nowhere in the *O'Mahony* decision did the Southern District claim as relevant to its extraterritorial analysis whether the underlying statutory violation that the whistleblower reported enjoys extraterritorial application.
19. Sarbanes-Oxley Act of 2002, Pub. L. 107-204, at § 301(4).
20. *See* SEC Rule 10A-3(m), 17 C.F.R. § 240.10A-3(a)(5). (Emphasis added.)
21. *See* SEC Act Release No. 33-8220 (9 Apr. 2003), 2003 SEC Lexis 846, at 71 (emphasis added). The SEC also appears vaguely to have taken the position that § 301 applies abroad at SEC Act Release No. 33-8220 (9 Apr. 2003).
22. 15.06.2005, file no. 5 BV 20/05.
23. EU Dir. 95/46/EC.
24. *McDonald's, CNIL Délibération nº 2005-110* (26 May 2005); *Exide Technologies/CEAC, CNIL Délib. nº 2005-111* (26 May 2005).
25. *SAS BSN—GlassPack* (*Tribunal de Grande Instance de Libourne*, 15 Sept. 2005).
26. *Document d'orientation adopte par la Commission le 10 novembre 2005 pour la mise en oeuvre de dispositifs d'alerte professionnelle….* (Unnumbered CNIL document dated Paris, 10 Nov. 2005).
27. Opinion 1/2006, 00195/06 WP 117 (1 Feb. 2006).
28. As a side note, whistleblowers who voluntarily provided original information to the SEC that led to the successful enforcement of the covered judicial or administrative action receive a portion of the monetary sanctions awarded (which is not less than ten percent, but not more than thirty percent, in total, of monetary sanctions exceeding 1 million dollars imposed in the action or related actions).
29. Although the issue of Section 922's extraterritorial applicability has not yet been addressed by a court, in *Peeza v. Investors Capital Corp.*, 2011 WL 767982, at *6 (D. Mass. 1 Mar. 2011), the court found that "congressional intent regarding the temporal reach of Section 922…to be far from clear," and so determined that retroactive application was not appropriate. Presumably, courts will have a like mindset in requiring strong "congressional intent" to extend temporal *or* geographic reach, and such an analogy is worth noting. *See also Riddle v. Dyncorp Int'l Inc.*, 733 F. Supp. 2d 743, 747-748 (N.D. Tex. 2010) (declining to extend the temporal reach of the whistleblowing provision of the False Claims Act, as amended by Dodd-Frank).
30. *Morrison*, note 4 *supra*, 130 S. Ct. at 2876-2877.
31. *Id.* at 2881.
32. SEC, Study on Extraterritorial Private Rights of Action, 2010 WL 4196006, at *4, n.1 (25 Oct. 2010).
33. H5237, Congressional Record –House, 30 June 2010.
34. *See, e.g.,* Press Release, SEC, *SEC Charges Technip with Foreign Bribery and Related Accounting Violations—Technip to Pay $98 Million in Disgorgement and Prejudgment Interest; Company Also to Pay a Criminal Penalty of $240 Million* (28 June 2010), http://www.sec.gov/litigation/litreleases/2010/lr21578.htm ($98 million "monetary sanction" recovered by the SEC); Press Release, SEC, *SEC Charges KBR, Inc. with Foreign Bribery; Charges Halliburton Co. and KBR, Inc. with Related Accounting Violations—Companies to Pay Disgorgement of $177 Million; KBR Subsidiary to Pay Criminal Fines of $402 Million; Total Payments to be $579 Million* (11 Feb. 2009), http://www.sec.gov/litigation/litreleases/2009/lr20897a.htm ($177 million "monetary sanction" recovered by the SEC); Press Release, SEC, *SEC Files Settled Foreign Corrupt Practices Act Charges Against Siemens AG for Engaging in Worldwide Bribery With Total Disgorgement and Criminal Fines Over $1.6 Billion* (15 Dec. 2008), http://www.sec.gov/litigation/litreleases/2008/lr20829.htm ($350 million "monetary sanction" recovered by the SEC).
35. A whistleblower is not entitled to recovery if he or she:

    > is, or was at the time the whistleblower acquired the original information submitted to the Commission, a member, officer, or employee of—(i) an appropriate regulatory agency; (ii) the Department of Justice; (iii) a self-regulatory organization; (iv) the Public Company Accounting Oversight Board; or (v) a law enforcement organization;
    >
    > is convicted of a criminal violation related to the judicial or administrative action for which the whistleblower otherwise could receive an award…;

> gains the information through the performance of an audit of financial statements required under the securities laws and for whom such submission would be contrary to [the requirements of the securities laws]; or
>
> fails to submit information to the Commission in such form as the Commission may, by rule, require.

Section 240.21F-4 of the SEC's final whistleblower rules expound on and add to these ineligibilities.

Shockingly, under the Act itself, whistleblowers who knowingly or recklessly participate in or aid and abet the securities law violation, and, thus, are subject to an SEC enforcement action themselves, but who are not *criminally* convicted, are entitled to the bounty. In reaction to this obvious failing, Section 240.21F-16 of the SEC final whistleblower rules makes whistleblowers ineligible for a bounty based on any portion of the monetary sanctions ordered against a company whose liability is based *substantially* on conduct that the whistleblower directed, planned, or initiated.

36. *See* Client Alert, Proskauer Rose LLP, *Recent FCPA and Anti-Corruption News Highlights the Ever-Growing Importance of Effective FCPA Compliance Programs* (22 Apr. 2010), http://www.proskauer.com/publications/client-alert/recent-fcpa-and-anti-corruption-news/.
37. *See, e.g.*, *Tamari v. Bache & Co. (Lebanon) S.A.L.*, 730 F.2d 1103, 1107-1108 (7th Cir. 1984).
38. *See, e.g.*, *Mormels v. Girofinance, S.A.*, 544. F. Supp. 815, 817-818 (S.D.N.Y. 1982).
39. *See* Regulation M, Official Staff Commentary, 12 C.F.R. part 213, supplement I, § 213.1-1.
40. *See* Regulation Z, Official Staff Commentary, 12 C.F.R. part 226, supplement I, § 226.1(c)-1.
41. *See Id.*
42. *See* Regulation B, Official Staff Commentary, 12 C.F.R. part 202, supplement I, § 202.1-2 (emphasis added).
43. *See* Regulation DD, Official Staff Commentary, part 230, supplement I, § 230.1(c)-1.
44. *See* Federal Trade Commission Staff Commentary on the Fair Debt Collection Practices Act, Section 806(3).
45. *See* Regulation C, Official Staff Commentary, 12 C.F.R. part 203, supplement I, § 203.2(e)-5, 203.2(e)-6.
46. *See* Regulation E, Official Staff Commentary, 12 C.F.R. part 205.
47. [2002] IRLR 109 (EAT).

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# Intellectual Property Aspects of the Free Trade Agreement Between the United States and Colombia

By Ernesto Cavalier

## I. Introduction: The CTPA IP Protection

The United States signed the Free Trade Agreement (also known as the Colombia Trade Promotion Agreement, or CTPA) with Colombia in 2006. The Treaty was approved by the Colombian Congress the next year, and approved by the Constitutional Court. The United States has now approved the Treaty.

Negotiations between Colombia and the U.S. were carried out by the administrations of President Bush in the U.S. and President Uribe in Colombia. Those negotiations concluded on 27 February 2006, and the treaty was signed in Washington, DC, on 22 November 2006.

Colombia and the United States have waited five years now to see the CTPA ratified by the U.S. The process of reaching the agreement was not an easy one, requiring Colombia to pass not only one but two different laws approving the CTPA, law 1143 of 2007 for the CTPA itself, and law 1166 of the same year for the protocol amending the CTPA (required by the Democrats in the U.S. Congress). Further, to comply with Colombian constitutional provisions, the CTPA was submitted to review by the Constitutional Court, which found the CTPA was not unconstitutional in its decisions C-750 and C-751, both of 24 July 2008.

After all these steps, the treaty underwent a difficult approval process in the U.S. Senate that ended with the recent agreements between President Obama and the leaders of the Republican party.

In the early fall of 2011, U.S. Trade Representative Ron Kirk said that "talks on passing the free-trade agreements with South Korea and Colombia depend on how soon a deal can be reached to pass the retraining program known as Trade Adjustment Assistance" (TAA),[1] a USD 2.1 billion program intended to allay claims by U.S. unions that the CPTA and the Korean FTA would displace many workers from current jobs.

While discussions went on as to the US economy, President Obama's jobs plan and its huge cost of $447 billion were seen as "short of what's needed"[2] and the United States Chamber of Commerce proposed a six-point plan for job creation, which included in its very first point the approval of the CTPA and the FTAs with Panama and Korea:

> ***Expand trade and global commerce***—Pass the three pending free trade agreements with South Korea, Colombia, and Panama to save 380,000 jobs and add hundreds of thousands of new jobs. Completing export control reforms, spurring exports to Europe and Asia, and protecting intellectual property through patent reform and shutting down rogue websites would create thousands of additional jobs.[3]

While the United States Chamber made it abundantly clear that improved intellectual property protection that would be achieved by CTPA and similar agreements in Korea and Panama is critical for the U.S. economy, the issue has not received the attention it should have. It is rightfully pointed out that web sites are a source of theft of IP, that lack of enforcement of IP regulations is a source of loss of jobs in the U.S., and that the higher standards of protection of IP in the CTPA will positively impact the U.S. economic performance. This was highlighted recently in the eighth round of negotiations of the Trans Pacific Partnership TPP Trade Agreement in Chicago, when the U.S. Chamber of Commerce hosted a panel on how "strong IP protection" plays a role "in promoting the vitality of the manufacturing, biotech, and recording industries and the American economy."

This is seen as crucial for continued sustainability of the U.S. economy, since "…IP-intensive industries drive 60 percent of U.S. exports and employ more than 19 million Americans…" and also because the economic growth and global competitiveness of the U.S. "…hinges on our ability to foster innovation and creativity," which is achieved in a large measure by offering protection to innovators and creators.[4]

Thus, it was in the interest of the United States to finalize completion of the FTA with Colombia in order to reap the benefits of the increased protection of intellectual property in Colombia, protection that will certainly continue to grow through measures that will be implemented in the near future, such as the so called "Lleras Law," which complements protection of copyrights on the Internet.

## II. Details of the CTPA: IP Protection

The relevant chapters in the CTPA in regard to intellectual property are: (i) Chapter 16 – Intellectual Property; (ii) Chapter 15—Electronic Commerce; (iii) Chapter 11—Cross-Border Trade in Services; and (iv) Chapter 6—Sanitary and Phytosanitary Measures.

We will refer below to the Colombian implementation of the treaty, in anticipation of its entry into force.

### A. Treaties

In Chapter 16 of the CTPA Colombia agreed to enter into several multilateral agreements. Among these are the following, with an indication of whether they are already in force.

- By the date of entry into force of the CTPA:
  - The *Convention Relating to the Distribution of Programme-Carrying Signals Transmitted by Satellite* (1974): Colombia has not yet acceded to this treaty.
  - The *Budapest Treaty on the International Recognition of the Deposit of Microorganisms for the Purposes of Patent Procedure* (1977), as amended in 1980: Colombia has not yet acceded to this treaty.
  - The *WIPO Copyright Treaty* (1996): In force for Colombia since 6 March 2002.
  - The *WIPO Performances and Phonograms Treaty* (1996): In force for Colombia since 20 May 2002.
- By 1 January 2008, or by the date of entry into force of the CTPA, whichever is later:
  - The *Patent Cooperation Treaty* (1970), as amended in 1979: In force for Colombia since 28 February 2001.
  - The *Trademark Law Treaty* (1994): Colombia has not yet acceded to this treaty, but it was approved by Law 1343 of 31 July of 2009, and approved by the Constitutional Court on 6 April 2011, by decision C-261-11.
  - The *International Convention for the Protection of New Varieties of Plants* (1991) (UPOV Convention): In force for Colombia since 13 September 1996.
- A third set of multilateral treaties was subject to "reasonable efforts" by the Parties to ratify or accede to:
  - The *Patent Law Treaty* (2000): Colombia has not yet acceded to this treaty.
  - The *Hague Agreement Concerning the International Registration of Industrial Designs* (1999): Colombia has not yet acceded to this treaty.
  - The *Protocol Relating to the Madrid Agreement Concerning the International Registration of Marks* (1989): Colombia has not yet acceded to this treaty, but it was approved by Congress and has been submitted to the Constitutional Court for approval.

### B. Legislation

Legislation on trademarks is already following what is provided in the treaty. Thus legislation has been enacted which provides that (i) scent and sound trademarks may be registered; (ii) collective and certification marks may be registered; and (iii) trademark licenses do not require registration.

### C. Other Steps

Colombia has taken steps required by the treaty, among them: (i) accession to the Madrid Protocol; (ii) increasing protection of clinical data for pharmaceutical and agricultural products; and (iii) additional protection of IP through strengthening the criminal laws.

#### 1. The Madrid Protocol

The Colombian Congress passed legislation to accede to the Madrid Protocol on 29 June 2011, through Law 1455 of 2011, approving the treaty. The Colombian constitution requires all international, multilateral or bilateral agreements to be scrutinized by the Constitutional Court, and the Madrid Protocol has gone to the Constitutional Court for review just recently: no decision has been issued yet on the treaty. However, it is likely the Court will not raise any constitutional issues against accession to this treaty, or require the Government to make reservations.

The Madrid Protocol is eagerly awaited by intellectual property practitioners and by trademark owners in Colombia and around the world. In particular, exporters from Colombia will greatly benefit from the ability to file for trademarks all over the world directly at the Colombian trademark office, enjoying also the benefits of filing at once for a large number of countries.

Just to give an idea about exports from Colombia, the country will export a total of USD 52 billion this year, of which about USD 16 billion are not energy and mining related, but relate to manufactured goods, agricultural products, food and cut flowers, for instance. Those exports reach a large number of countries: of course the USA, Canada, and European countries, but also Central and South America, the Caribbean, as well as in regions or countries such as East Asia, Japan, India, China, and also other less evident countries like Nigeria, Turkey, and Kazakhstan. One of the "natural" markets for Colombian goods is Central America and the Caribbean, where exports from Colombia compete head to head with Mexican and Brazilian products.

Thus, the Madrid Protocol will be of benefit to all Colombian exporters who have to file in multiple jurisdictions.

### 2. Protection of Clinical Data for Pharmaceutical and Agricultural Products

This protection is provided in Colombia by Decree 2085 of 2002 for pharmaceutical products, and by Decree 502 of 2003 for agrochemicals. The former provides for a maximum term of protection of five years, while the latter provides for a ten-year term of protection.

### 3. Strengthening the Criminal Laws

One of the many achievements of President Uribe's Government was to pass legislation on hotly debated issues, such as increased protection of intellectual property. One of the more prominent deficiencies of intellectual property regulations of Colombia was compliance. While legislation was there, ineffectiveness and delays in the civil courts made it almost impossible to enforce trademark and copyrights protection until recently.

The Government decided it was time to provide IP owners stronger and more effective measures to protect their valuable assets. Thus, legislation was passed to criminalize some violations of IP laws, or to strengthen existing provisions by amending them, making them more encompassing and wider in coverage. Since additional means to avoid trade in counterfeited goods through regulation of border measures was already undertaken in Decision 486, but lacked the necessary instructions and implementing regulations for customs, Decree 4540 of 22 December 2006 was issued regulating the matter.

Hand in hand with regulations criminalizing IP, a law was passed regarding cybercrime, a much debated and awaited piece of legislation, but extremely useful and updated.

These new criminal law provisions are discussed in Part III below.

## III. Criminal Law Reform

### A. Crimes Involving Intellectual Property

To supplement the new provisions in the Criminal Code, which were adopted by Law 599 of 2000, the following provisions were added to it regarding crimes against intellectual property.

### 1. Article 306 of Criminal Code

Article 306, which was modified by Article 4 of Law 1032 of 2006, provides protection against infringement of the rights of breeders of plants varieties. Thus anyone who fraudulently uses a commercial name, trademark, patent, utility model, or industrial design, or usurps rights of breeders of new plant varieties which are legally protected, or creates confusion with a legally protected plant variety, will face a prison term of four to eight years and a fine of 26.66 times to fifteen hundred times the monthly legal minimum wage.

### 2. Article 307 of Criminal Code

Article 307 protects patent owners, whether of process or product patents. Thus, whoever manufactures product without the authorization of those who have the legally protected right, or uses without permission a patented process, will face a prison term of one to four years and a fine of twenty times to twenty-one thousand times the monthly legal minimum wage.

### 3. Article 308 of Criminal Code

Article 308 protects against violations of industrial or commercial secrets. Thus anyone who uses, discloses or divulges a discovery, scientific invention, process or industrial or commercial application, coming to his knowledge by virtue of his office, or profession which must remain in reserve, will face a prison term of two to five years and a fine of twenty times to two thousand times the monthly legal minimum wage.

### 4. Article 270 of Criminal Code

Article 270 is related to violations of moral rights. It provides for a prison term of two to five years and a fine of twenty times to two hundred times the legal monthly minimum wage for anyone who

- has published, in whole or in part, without prior express authorization of the right holder, an unpublished work of literary, artistic, scientific, film, audiovisual or sound recording, computer program or software;
- has registered in the Copyright Office with a different name than the authors, or with a title changed or deleted, or with the text altered, defaced, modified, or falsely mentioning the name of the editor or producer of a work of literature, artistic, scientific, audiovisual or sound recording, computer program or software; or
- by any process changes, without express prior authorization of the owner, a work of literary, artistic, scientific, audiovisual or sound recording, computer program or software.

### 5. Article 271 of Criminal Code

Article 271, which was modified by Article 2 of Law 1032 of 2006, protects copyrights against infringement. It provides for a prison term of four to eight years and a fine of 26.66 times to one thousand times the legal monthly minimum wage for anyone who without authorization

- reproduces a work of literary, artistic, scientific, film, or transports, stores, distributes, imports, sells, offers, purchase for sale or distribution, or supplies such reproductions;
- publicly displays literary or artistic works;

– rents or commercializes phonograms, video recordings, computer programs or software or cinematographic works;

– reproduces or commercializes plays or musicals;

– provides, performs, or uses by any means or process the communication, fixation, performance, exhibition, marketing, dissemination or distribution and representation of a work protected under this article;

– retransmits, fixes, reproduces, or by any means audio or audiovisual, divulges emissions from broadcasters; or

– receives, disseminates or distributes by any means the emissions from subscribed television.

#### 6. Article 272 of Criminal Code

Article 272, which was modified by Article 3 of Law 1032 of 2006, states the crime of violation of the protection mechanisms of copyright and related rights, and other frauds. Thus it provides for a prison term of four to eight years and a fine of 26.66 times to one thousand times the legal monthly minimum wage for anyone who

– exceeds or avoids technological measures to restrict unauthorized uses;

– suppresses or alters essential information of electronic rights management, or imports, distributes or communicates copies with the information suppressed or altered;

– manufactures, imports, sells, leases or distributes to the public a device or system for decoding an encrypted satellite signal carrier programs, without authorization of the legitimate distributor of that signal, or in any way, avoids, evades, disables or deletes a device or system, allowing the owners to control the use of their works or phonograms, or enable them to prevent or restrict any unauthorized use of these; or

– presents false or altered information to get the profit of economic copyrights.[5]

### B. Cybercrime

Regarding cybercrime, the Colombian government submitted to Congress two bills that were passed, namely, Law 1266 of 2008[6] and Law 1273 of 2009. The former is a law for the protection of personal information, or *habeas data* law, and the latter is a law that protects individuals from cybercrime.

#### 1. Law 1266 and Personal Data

Law 1266 of 2008 defined the term personal data as "any piece of information linked to one or more specific persons or persons to be determined, or that may be associated with a physical or legal person." It requires companies to take special care in handling the personal data of its employees, since the law requires anyone who "extracts" and "intercepts" such data to redress its owner.

#### 2. Law 1273 and Title VII bis

Law 1273, in force since 5 January 2009, amended the Criminal Code so that a new area of protection of legal rights was created, that is, data protection and information, including systems that use information technologies and communications, to create a new legally protected interest called information and data protection. New criminal offenses related to computer crimes and the protection of information and data, were created, imposing prison penalties up to one hundred twenty months and fines up to fifteen hundred times the minimum statutory monthly wage.[7]

This Law 1273 criminalizes a range of behaviors related to the handling of personal data. Technological advances and their misuse to misappropriate assets of third parties by the cloning of bank cards, alteration and hacking of computer systems, and electronic transfers of funds through manipulation of software and misuse of ATMs, among others, is a daily occurrence worldwide. Statistics indicate that, during 2007, companies lost more than COP $6.6 billion in the wake of computing crime in Colombia.

Law 1273 also added a new Title VII bis to the Colombian Criminal Code, called "Information and Data Protection." The new title is divided in two chapters: (i) crimes that target computers and directly attack confidentiality, integrity and availability of information systems; and (ii) crimes facilitated by computer networks or devices, the primary target of which is independent of the computer network or device.

#### (a) First Chapter

The first chapter of Law 1273, on crimes that target computers and directly attack confidentiality, integrity and availability of information systems, added the following articles.

**(i) Article 269A: Abusive access to a computer system.**

Anyone who, without permission or outside the agreement, accesses in whole or in part a computer system, whether or not protected with a security system, or stays within the same, against the wishes of those who have the legitimate right to exclude access, will be held liable to a prison term of forty-eight to ninety-six months and a fine of one hundred times to one thousand times the minimum statutory monthly wage.

**(ii) Article 269B: Illegitimate obstruction of computing systems or telecommunications networks.**

Anyone who, without being authorized to do so, prevents or hinders the normal operation of or access to a computer system, the data contained therein, or to a telecommunications network, will be held liable to a prison

term of forty-eight to ninety-six months and a fine of one hundred times to one thousand times the minimum legal monthly wage, provided that the conduct does not constitute an offense punishable by a higher penalty.

**(iii) Article 269C: Data interception.**

Anyone who, without prior court order, intercepts data on its origin, destination or within a computer system, or the electromagnetic emissions from a computer system transporting them, will be held liable to a prison term of thirty-six to seventy-two months.

**(iv) Article 269D: Computer damage.**

Anyone who, without being authorized to do so, destroys, damages, deletes, deteriorates, alters or deletes computing data, or an information processing system or its parts or logical components will be held liable to a prison term of forty-eight to ninety-six months and a fine of one hundred times to one thousand times the minimum legal monthly wage.

**(v) Article 269E: Malicious code (malware).**

Anyone who, without being authorized to do so, creates, traffics in, acquires, distributes, sells, sends, imports into or exports from the country malicious software or other computer programs producing harmful effects, will be held liable to a prison term of forty-eight to ninety-six months and a fine of one hundred to one thousand times the minimum legal monthly wage.

**(vi) Article 269F: Violation of personal data.**

Anyone who, without being authorized to do so, for its own benefit or for the benefit of a third party, obtains, compiles, subtracts, offers, sells, exchanges, sends, buys, intercepts, discloses, modifies or uses personal codes, personal data contained in files, archives, databases or similar means, will be held liable to a prison term of forty-eight to ninety-six months and a fine of one hundred times to one thousand times the minimum legal monthly wage.

**(vii) Article 269G: "Phishing" (a form of fraud and identity theft for capturing personal information).**

Anyone who, with the illegal purpose of "phishing" and without authority to do so, designs, develops, traffics in, sells, runs, programs, or sends electronic pages, links or pop-ups, will be held liable to a prison term of forty-eight to ninety-six months and a fine of one hundred to one thousand times the minimum legal monthly wage, provided that the conduct does not constitute an offense punishable by a higher penalty.

The same penalty will apply to anyone who uses or modifies domain names, so that the user enters a different Internet Protocol (IP) address in the belief that it is accessing its bank or another personal or trusted site, if the conduct does not constitute an offense punishable by a higher penalty.

The penalty specified in Article 269G will be increased by one-third to one-half if the agent has recruited victims in the chain of crime.

Article 269G defines what is commonly called "phishing" as a scheme or scam that uses e-mails, but scammers are increasingly using other means of propagation, such as instant messaging and social networks. According to the Computer Crimes Unit of the Colombian Judicial Police (Dijin), millions of dollars are stolen through the use of "phishing" schemes.

**(viii) Section 269H.**

Article 269H increases the penalty by one-half to three-quarters for aggravating circumstances when any of the following conduct occurs.

- The license is cancelled on networks or computing systems belonging to the state.
- The criminal is a public servant acting in his official capacity.
- The criminal takes advantage of the trust placed by the holder of the information in the criminal, or on the individual who has a contractual relationship with it.
- The criminal reveals or publicizes the content of information to the detriment of another.
- The criminal obtains benefits for himself or a third party.
- The criminal acts with terrorist purposes or creates a risk to safety or national defense.
- The criminal uses a third party acting in good faith as an instrument.
- The criminal is a person engaged in the administration, management, or control of that information. In this event, the person will also be disqualified from the exercise of any profession related to information systems, for up to three years.

### (b) Second Chapter

The second chapter of Law 1273 related to crimes facilitated by computer networks or devices, the primary target of which is independent of the computer network or device, and includes the following new articles.

**(i) Article 269I: Theft through computers and the like.**

Anyone who, breaking computer security measures, engages in the conduct described in Article 239[8] by manipulating a computer system, an electronic, computing or other similar network or impersonating a user to the established authentication and authorization systems will be liable for the penalties mentioned in Article 240 of the Penal Code[9] (a prison term of three to eight years).

**(ii) Article 269J: Transfer of assets through computer or device manipulation without the consent of the owner.**

Anyone who, for profit and using any computer manipulation or similar device, achieves the transfer of any assets without the consent of the owner, to the detriment of another, provided that the conduct does not constitute an offense punishable by heavier penalty, will be liable to a prison term of forty-eight to one hundred twenty months and fine of two hundred times to fifteen hundred times the minimum legal monthly wages.

The same sanction will be imposed upon anyone who manufactures, introduces, has or gives a computer program aimed to the perpetration of the crime described in the preceding paragraph, or to the perpetration of a scam.

If the conduct described in the two preceding paragraphs has a value exceeding two hundred times the minimum legal monthly wage, the penalty will be increased by one-half.

Likewise, Law 1273 adds as an aggravating circumstance under Article 58 of the Criminal Code for the performance of punishable acts by using electronic or computing means.

## IV. Conclusion

The protection of intellectual property in Colombia, as a result of entering into the CTPA, has been improved substantially in the following respects: (i) state-of-the-art protection for U.S. trademarks; (ii) protection for copyrighted works in a digital economy; (iii) stronger protection for patents and test data; and (iv) tough penalties for piracy and counterfeiting.

The Treaty also contemplates agreements on other important subjects which were entered in side letters, including (i) biodiversity and traditional knowledge, and (ii) retransmission of television signals (whether terrestrial, cable, or satellite) on the Internet.

## Endnotes

1. Wall Street Journal, 12 Sept. 2011.
2. "The president's $447 billion proposal, The American Jobs Act, includes provisions the administration believes will encourage small businesses to expand and hire. It would cut in half the payroll tax for most businesses and extend a complete payroll holiday for firms that add new workers or increase wages. In an attempt to reduce the long-term unemployment many out-of-work Americans are experiencing, the president proposes to give a $4,000 tax credit to companies that hire anyone who has spent more than six months looking for a job." Free Enterprise Magazine, 9 Sept. 2011.
3. Donohue, *An Action Plan For Jobs—Now*, Enterprise Magazine, 6 Sept. 2011.
4. Osika, *ChamberPost – A Blog for Business* – 12 Sept. 2011 at http://www.chamberpost.com/2011/09/intellectual-property-rights-protection-in-a-21st-century-trade-agreement/.
5. Translations and summary drafted by Angela Correa of the IP Area of Posse, Herrera & Ruiz.
6. A new data protection law was passed by Congress on 16 December 2010, and sent on 31 December 2010 to the Constitutional Court for control; since it is a so called "statutory law," it must undergo a Constitutional Court review process to ensure that it conforms to the Colombian Constitution.
7. In 2011 the legal minimum wage in Colombia is COP $535,600.00. Therefore the maximum fines would be COP $803,400,000, equivalent to US$446,333 using an exchange rate of COP $1,800 to one U.S. Dollar.
8. Theft: to seize a movable good of a third party with the purpose of obtaining benefits for himself or herself, or another.
9. Qualified theft.

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# Perspectives on Utilizing Tax Incentives for Infrastructure Ventures in Latin America: A Case Study

*Editor's Note: The articles that follow deal with utilizing tax incentives for infrastructure ventures in Latin America, as viewed from the perspective of four different Latin American countries, namely, Argentina, Brazil, Colombia and Mexico. The articles include discussion of general tax treatment, as well as incentives available for investing in the construction, operation, and maintenance of a highway in each of the four countries. The following is the case study that forms the basis of each of the four articles.*

The governments of Argentina, Brazil, Colombia, and Mexico (hereinafter individually referred to as the "investment jurisdiction") have opened public bids for the construction, operation, and maintenance of a highway connecting two major cities in each of the countries. According to the terms of the public bids, the corresponding governments will grant a concession over the highway for thirty years. The relevant governments will own the highway and installations at all times.

Highways, Inc., is a United States corporation whose primary business is the construction of highways in the U.S. and abroad. Highways, Inc., operates in most countries of the world, except in Latin American countries.

Due to the world's financial situation, Highways, Inc., has recently decided to expand its business to Latin American countries and has identified the public bids opened by the aforementioned governments. Highways, Inc., is willing to participate in just one of the public bids. Its decision to participate in only one of the bids is mainly driven by financial reasons and, therefore, it is seeking advice in each of the jurisdictions to determine which of them would offer the best conditions to maximize the financial benefit of its investment (i.e., return of capital).

Highways, Inc., has considered three possible structures to participate in the public bids:

- to participate as a foreign entity;
- to form a branch or incorporate a domestic entity, such as a special purpose vehicle (SPV), in the relevant jurisdiction and participate through such branch or SPV; or
- to enter into a joint venture agreement with a local company either to incorporate an independent domestic SPV and participate through the latter, or to participate through a noncorporate joint venture vehicle.

In all three possible structures, Highways, Inc., or one or more of its subsidiaries will have to deploy personnel in the corresponding country so it can perform under the government contract.

The infrastructure project will be financed totally by the private sector—either through equity contributed by Highways, Inc., or through debt. In the latter case, traditional loans could be granted by independent local or foreign financial institutions. Other independent local or foreign parties (not financial institutions) could also grant traditional loans to the SPV. The SPV could also issue bonds and place them in the local public market to be acquired by both foreign tax and domestic tax residents. Finally, the SPV could also receive loans from Highways, Inc.

# Utilizing Tax Incentives for Infrastructure Ventures in Latin America: The Argentinian Perspective

By Bastiana T. Locurscio

## I. Introduction

The purpose of this article is to analyze the case study set out at the beginning of this series of articles. This analysis, submitted for discussion, is divided into six topics. These topics are dealt with in Parts II-VII.

## II. The Vehicle

In choosing the best vehicle to participate in an Argentine contract bid, the kind of vehicle and the time to establish it are factors for consideration. Any decision on these factors should be based on consideration of tax and corporate issues and may be affected by domestic rules and regulations, as described below.

### A. When to Establish the Vehicle

Argentine corporate law does not require that a vehicle be previously established in order to participate in a bidding process. However, establishing a vehicle at an early stage of the bidding process may be mandatory in accordance with administrative laws regulating a particular bidding procedure and the bidding documents. If there is no such registration requirement, Highways, Inc. could incorporate the Special Purpose Vehicle (SPV) at closing in order to minimize expenditures in case it is not the successful bidder.

The Argentine Corporation Law establishes that the law of the place of incorporation governs the existence and legal form of companies incorporated outside Argentina.[1] These companies may act in Argentina on an irregular time basis, such as by participating in a bidding process. They must register with the Office of Corporations only if they intend to act in Argentina on a regular basis.[2] Developing a project or taking part in an unincorporated joint venture to develop a project implies a regular conduct of business in Argentina and therefore it is in that moment when registration is mandatory pursuant to the Argentine Corporation Law.[3]

Nevertheless, certain administrative permits are generally required to participate in the bidding process. Obtaining such permits may or may not require registration. In case obtaining such permits requires registration as a preliminary step, then registration of the vehicle is necessary, even if such registration is not explicitly required in the bidding conditions. In connection with construction activities, there are two certificates that generally apply: (i) an Enrollment Certificate in the State Suppliers Database (SIPRO, as per its acronym in Spanish); and (ii) an Enrollment Certificate in the Federal Registry of Builders of Public Works Constructors.[4] Both certificates can only be obtained by submitting proof of registration in the Registry of Commerce. The former Certificate is not required for foreign companies,[5] while the latter certificate may or may not be waived, depending on the technical and financial capacity of the participants.[6]

The bidding documents may also require registration. That is the case for bidding documents that demand that the participants have a tax identification number, which in turn requires registration with the Office of Corporations.[7] That is also the case of National Bidding Proceedings (as opposed to International Bidding Proceedings), since foreign companies can only participate in them once they have set up a branch in Argentina.[8]

Lastly, certain Argentinian laws, called "Contract Domestic Laws," establish that the Government should hire domestic companies to perform construction activities or to be suppliers of construction and other services.[9] A domestic company is defined as a company domiciled and authorized to act in Argentina and that has eighty percent of its directors, senior leaders and professionals domiciled in the country. Only in exceptional cases can the Government hire foreign companies. Therefore, bidding documents usually establish that participants must be domestic companies. These bidding documents also establish that foreign investors are to set up a domestic company—in the manner described—prior to taking part in the bidding proceedings.[10] The compatibility of these laws and compromises made by Argentina at an international level—especially the standard of national treatment—is beyond the scope of this analysis.[11]

### B. Choosing the Vehicle

Commonly, the vehicle can be a UTE (a kind of unincorporated joint venture[12]), a branch, or a subsidiary. Bidding documents may require participants to be associated with a domestic entity or foster such association by evaluating the offers and considering previous performance of similar activities in the domestic market.[13] Changing the SPV during or after the bidding process is not advisable for tax, cost, and time consumption reasons.[14] Also, assignments between different structures may require governmental authorization.[15] Therefore, the pros and cons for a certain vehicle should be weighed at the beginning. If the bidding conditions do not require a specific structure, a subsidiary is generally the best option, for the reasons discussed below.

### 1. UTEs

Highways, Inc. may take part in a UTE. A joint venture with a third party can adopt the form of a company (a partnership, a corporation, a *de facto* entity, etc.) or the joint venture can be structured as an associative agreement without the establishment of a new legal entity (such as under a temporary union of companies or "UTE").[16] Since a UTE does not have legal capacity, acts are directly attributed to its members. However, a limited legal capacity is assigned for tax purposes to UTEs, as well as to other business structures, even when they are not considered legal entities under the Argentine Corporation Law. Thus, UTEs are qualified as taxpayers in the Value Added Tax Law[17] and most Turnover Taxes Laws.[18] UTEs are also appointed as withholding and collection-at-source agents.[19]

UTEs are regulated under the Argentine Corporation Law as associative agreements, whereby two or more entities join in order to carry out work, services or supply.[20] The agreement must be registered with the Office of Corporations in a proceeding that is much simpler and cheaper than the proceeding applicable to branches and subsidiaries, and this is an important advantage of this type of vehicle. Also, new members can be added while a project is being developed within a UTE structure in order to fund it. This alternative is not available to branches.

However, prior to participating in a UTE, Highways, Inc. must register with the Office of Corporations. In the event Contract Domestic Laws apply to the bidding process, the SPV to be registered must qualify as a domestic company in the manner specified in Part II.A above.[21]

There is no consensus on whether the liquidation process, which is mandatory for companies, is applicable to UTEs. In the event that the liquidation process is not considered applicable to UTEs, an advantage of the UTE would be that certain costs and a time-consuming liquidation process might be avoided once the project is completed.[22]

However, there are some drawbacks to be considered. The members must appoint a UTE representative. This representative must be invested with enough power to exercise rights and undertake obligations to carry out the business purpose of the vehicle.[23] One of the disadvantages of a UTE is that all members must agree unanimously to revoke powers granted to the representative without cause. Even if there is cause, an absolute majority is needed.[24]

Another disadvantage relates to the operative fund. The members of the UTE must constitute an operative fund. This fund belongs to the members, since the UTE has no legal capacity. Therefore, creditors of a member can claim their rights over the portion of the fund that belongs to that member. This may lead to a lack of funds for the UTE to keep on operating.[25] Arrangements with creditors and bankruptcy proceedings related to any members will also affect the UTE fund.

Under the Argentine Corporation Law, members are not presumed to be jointly and severally liable.[26] However, bidding documents generally require the members of a UTE to be jointly and severally liable toward the grantor.[27] Also, members of the UTE are jointly and severally liable for unpaid taxes due by the UTE.[28] Members of other business structures do not have to bear such liability. Thus, for example, stockholders of a corporation are generally not responsible for the corporation's taxes.

Assuming that members of the UTE are corporations, limited liability companies and UTEs bear almost the same tax burden. However, since UTEs do not qualify as taxpayers for most taxes that UTE members are directly responsible for, in certain particular situations the effect of taxes may change.[29]

### 2. Branches

Highways, Inc. may do business in Argentina by setting up a branch. For that purpose, Highways, Inc. must register with the Office of Corporations, proving its regular incorporation in its country of origin, establishing an Argentine domicile, and appointing a person who will be in charge of the branch. This registration is simpler and cheaper than the registration required for subsidiaries. However, the timing and costs differences are so insignificant so as to have little if any impact on the decision of choosing the vehicle. Additionally, in the event Contract Domestic Laws are applicable to the bidding process, the vehicle to be registered must qualify as a domestic company as specified in Part II.A above. Other aspects that should be kept in mind are the following.

(a) *Capital:* The Argentine Corporation Law does not require branches to have capital assigned to them. However, special laws (such as the Argentine Law on Insurance Institutions[30] and the Law on Financial Institutions[31]) require a certain capital to perform determined activities. In all other cases, foreign entities can choose whether to assign capital to the branch. Assigning capital lets capital assignments be clearly differentiated from loans. This is useful both for foreign exchange control and for tax purposes.[32] When the branch has an assigned capital, it cannot be diminished and the net equity must exceed such amount.[33] The capital is a means of recourse for contract parties that there are assets in Argentina to execute upon in the event of a breach of the relevant agreements.[34] In the case of an arrangement with creditors or bankruptcy, local creditors have a priority claim on the assets located in Argentina.[35]

(b) *Liability:* Even when there is capital assigned to the branch, the foreign entity is wholly liable for the activities undertaken in Argentina.[36] This liability can be limited by means of a subsidiary structure.

(c) *Funding:* Unlike UTEs and subsidiaries, the participation of new members in the business structure is not possible, since branches are not legal entities different from the foreign entities that establish them. For the same reason, they cannot go public. However, branches of joint stock corporations incorporated abroad can issue private bonds.

(d) *Taxes:* Taxes applicable to branches are similar to the taxes levied on subsidiaries.[37] However, a subsidiary may have some tax advantages when a foreign entity wishes to exit the project. Sales of shares made by foreign entities are exempted from income tax,[38] while transfers of on-going concerns in a branch scenario are subject to income tax. Also, there may be tax differences based on the tax treatment of the investment in the investor's county of residence or incorporation (such as U.S. tax laws). An example is treatment of losses and the possibility to offset Argentine losses against U.S. income with a branch as opposed to a subsidiary.

### 3. Subsidiaries

Highways, Inc. may establish an Argentine subsidiary. The Argentine Corporation Law requires at least two partners.[39] The most common types of legal entities are joint stock corporations ("*sociedades anónimas*") and limited liability companies ("*sociedades de responsabilidad limitada*"). In both cases the partners' liability is limited to the capital they contributed.[40]

As an additional advantage, the management of subsidiaries is simpler than the management of a UTE. This is because the stability of the UTE representative may become an obstacle in the development of the project, and because the UTE decision-making process is usually more complex. Also, the SPV will have legal capacity so as to directly enter into agreements with contractors and keep an equity different from the equity of their partners, aspects that may lead to better and simpler contracting terms in its relations with third parties. The management is also simpler than that of a branch, since most decisions in a branch must be taken abroad and documents related to them must be legalized and registered before being valid and legal in Argentina.

Large-scale investments generally adopt the form of a joint stock corporation because of the financial tools available to them: they can go public, issue private bonds, easily include new partners, etc.

As for the disadvantages—and depending on the relationship between the stockholders or members—it must be considered that under the form of a company, the stockholders have a common equity subject to the risks of the business. The amount of this equity must be appropriate to the purposes of the entity. Also, Highways, Inc. should consider how the awarder evaluates previous performance of similar activities to decide which vehicle to choose. If the experience of the bidders' shareholders (as Highways, Inc. may be in case it uses a subsidiary) is not taken into account, a branch will have more chances to be the awardee than a subsidiary.[41] This is so because participating through a branch will let Highways, Inc. benefit from its prior experience.

Please note that the following discussions of the various topics are based on the premise that the vehicle is a subsidiary.

## III. The Stockholders

Argentine Corporation Law establishes that companies incorporated outside Argentina intending to become stockholders of Argentine companies must register such status with the Office of Corporations.[42]

Argentina does not have a general Double Taxation Treaty, or DTT, with the United States.[43] Therefore, if Highways, Inc. directly incorporates the SPV (being one of its shareholders), no DTT will apply to the relationship between the SPV and Highways, Inc.[44]

Shareholders may be taxed: (i) on the dividends they are paid; (ii) on the shares they own in the domestic entity; (iii) on the remittances they received in a liquidation process; and (iv) on the sale of their shares or equity interests in the domestic entity.

The lack of a DTT means that the general tax treatment applies to these aspects of the stockholder-SPV relationship. Royalties, interest and other income received by shareholders is not received in their capacity as stockholder and therefore is not included in this specific topic for discussion. From a tax planning perspective, taxation of the items listed in (i) to (iv) of the foregoing paragraph must be considered both in the country of the SPV and in the country of residence of the stockholder. This analysis will lead to a determination whether it is better to invest directly through Highways, Inc. or instead to make such investment through a subsidiary of Highways, Inc. located in a jurisdiction that has executed a DTT with Argentina.

### A. Taxation of Dividends

Argentina does not tax dividends,[45] except for some special cases.[46] Only in these special cases is tax planning on dividends worthy of attention from an Argentine standpoint.

Dividends are taxed if accounting income that exceeds taxable profits[47] is distributed (this tax is called the "equalization tax"). The same rule applies to the remit-

tance of funds by branches of foreign entities located in Argentina.

When dividends are taxed, a substitution regime applies and the domestic entity must pay the tax applicable to the shareholders. The tax rate is thirty-five percent on the amount of accounting income that exceeds taxable profits. Dividends distributed by domestic corporations are considered to be Argentine source income and therefore subject to a withholding tax when paid to nonresident persons. This rate may change to ten or fifteen percent if the shareholder resides in a country that has executed a treaty to avoid double taxation with Argentina.[48]

Therefore, tax planning with an investor in a third country with a DTT with Argentina may be considered in case the equalization tax will have to be repeatedly paid for any reason. Nevertheless, if the investment is made through a subsidiary with the main purpose of using this tax benefit, the concepts of abuse of treaties and effective beneficiary will come into play, and therefore must be carefully analyzed.[49]

### B. Taxation of Shares

Legal entities incorporated in Argentina and local branches pay a tax on the shares and equity interests held by their owners. This substitution regime applies to cases in which the equity owners are (i) individuals, (ii) undivided inheritances and (iii) legal entities domiciled abroad. The tax rate is one-half percent on the proportional equity value of the shares and equity interests.

Most DTTs executed by Argentina do not include personal assets clauses restricting the application of taxes on shares to the country where their owner is domiciled. However, DTTs like the one executed between Argentina and Spain include this type of clause. Considering that Spain has also entered into a DTT with the United States, the combination of the Argentine, Spanish and United States tax burden in those circumstances should be compared with the tax burden on a Highways, Inc. direct investment in order to determine the most convenient tax planning structure. Nevertheless, whether the DTT is being abused shall be carefully considered in designing the structure. The substance of the entity in the DTT country and its decision capacity on the investment are among the aspects that should be taken into account for such purpose.

### C. Taxation of Sales of Shares

Sales of shares made by foreign entities are not subject to income tax,[50] which makes tax planning with a third entity between the SPV and Highways, Inc. not worthy of consideration from an Argentine standpoint. This type of planning should be done considering the level of taxation of this income in the United States (as opposed to alternative third countries).

## IV. Funding

There are different instruments that may be used for funding the entity. Choosing a certain instrument should be based not only on a tax analysis but also on market conditions, type of activities being undertaken, and the like. The Argentine Tax Authorities have recharacterized many funding instruments, disregarding the classification that has been made by the parties to the agreement. For example, debts have been recharacterized as capital contributions, and preferred shares have been classified as debts. The recharacterization results not only in a different tax treatment and the obligation to pay interest but it is also commonly accompanied by fines and other punishments. Therefore, the nature of the instrument to be used shall be carefully analyzed. Some of these instruments, their tax treatment and the opinions issued in relation to them, are analyzed below.

### A. Capitalization

Funds can be obtained through capitalization. Different types of shares can be issued. For example, the SPV can issue privileged stock (*i.e.*, stock that grants more than one vote per share) or preferred stock (*i.e.*, stock that grants additional economic rights such as priority over common stock in the payment of dividends or a fixed dividend per year, etc.). Also, the SPV can choose between private equity financing and going public.

Income tax is not generally levied on dividends paid by domestic entities or on funds remitted by branches. However, dividends are taxed at thirty-five percent if the SPV distributes accounting income exceeding taxable profits. In these cases, a thirty-five percent rate of income tax applies. This rate may be reduced if a DTT applies. Instruments related to the capitalization process are generally exempted from the stamp tax.

Benefits derived from capitalizing the entity are manifold: there are generally fewer restrictions on the use of the money than the restrictions set by lenders; capitalization enables the entity to improve its debt-equity ratio and borrow on better terms, if necessary; and there is no value added tax involved.

However, payments made to investors cannot be deducted by the domestic entity and increasing the capital increases both Minimum Presumptive Income Tax payments as well as the amount due for the Personal Assets Tax on shares.[51]

#### 1. Going Public

The SPV can go public. Nevertheless, this alternative may not be available from the very first moment, since it is generally understood that only companies with a reasonable history of positive cash flow are good candidates for going public.[52]

Complying with requirements established by the stock exchange and regularly providing public access to information about the company may enhance the SPV's reputation and improve the terms of contracting.[53] Nonetheless, going public has some drawbacks, such as reporting requirements, public disclosure of information, and separation of ownership and control.[54]

#### 2. Preferred Stock

Issuing stock generally implies having third parties involved in the management and operation of the business. However, issuing preferred stock allows entities to obtain funds without granting voting rights similar to the rights granted by common stock. Lenders do not have voting rights either. Also, preferred stock entails lower risks in the event of insolvency, which is characteristic of loans as well.

These voting rights and risks differences have led the Federal Administration of Public Revenue (by its Spanish acronym AFIP) to inspect closely this kind of stock. This inspection is made in order to determine whether what is really a loan is being disguised with a preferred stock structure. Preferred stock meeting the following criteria might not be considered a capital contribution:[55]

- Fixed compensation.
- Stock redemption guaranteed after a certain period of time.
- Lack of voting rights.

### B. Loans

Funding with loans is the most common alternative to capitalization. Loans can be granted for a specific purpose (e.g., for financing purchases of certain assets) or without a specific aim.

#### 1. Stamp Tax

The Stamp Tax is levied on instruments related to the loan at a rate of around one percent. If the main instrument pays the tax, guarantees are generally exempted.

#### 2. Income Tax

#### (a) Deduction of Interest

Interest can be deducted by the payor upon accrual. Nevertheless, payments made to related parties residing abroad may only be deducted upon payment (and not upon accrual, as the general rule establishes). There are some authors who argue for the application of the accrual method for payments made to parties residing in a country that entered into a DTT with Argentina,[56] but this is still a minority position.

Thin capitalization rules may apply when (i) there is an inadequate relation between the net equity and the liabilities of the domestic payor, under the parameters set forth ad hoc in the Income Tax Law; (ii) the interest paid is not subject to a thirty-five percent effective withholding rate (that is, a thirty-five percent rate on a legally presumed income of one hundred percent);[57] and (iii) the interest is paid on debts to controlling non-resident persons. In these cases, a portion of the interest may not be deductible for the local entity and may be treated as dividends.[58] Some of the DTTs executed by Argentina specifically allow the application of thin capitalization rules in treaty contexts.[59] However, there is not a general agreement on whether thin capitalization rules may apply in DTT contexts whenever such an allowance was not made.[60]

The AFIP has recharacterized loans as capital contributions and has therefore denied deduction of interest under certain circumstances. For this purpose, the AFIP has considered whether the loan instruments were duly dated, whether there was interest set, whether the capital was cancelled or was capitalized, and the debtor's high debt/equity ratio, among others.[61]

#### (b) Income Tax on Interests

If the lender is a domestic entity, the income must be included in its declaration of income for income taxation. Domestic entities are generally subject to a thirty-five percent rate. If the lender is a foreign entity, income tax is withheld by the payor at a thirty-five percent rate on the portion of the payments presumed to be income. The tax may be reduced if a DTT applies. The portion presumed to be income varies depending upon, among other parameters, the origin of the income, the parties to the relevant agreement, the registration or non-registration of the agreement. In relation to interest on loans taken by domestic entities that are not financial entities, the portions of the payments presumed to be income are:

(i) Interest derived from import financing granted by suppliers of depreciable fixed assets (except for automobiles): forty-three percent;

(ii) Interest paid to a bank or financial institution located in a jurisdiction where standards of the Basel Committee on Banking Supervision apply: forty-three percent;

(iii) Interest not included in (i) and (ii): one hundred percent.

A grossing-up calculation must be done in case a payor residing in Argentina (the withholding agent) assumes the payment of the tax applicable to the non-resident person. However, grossing up does not apply in the case of payments of interest related to loans applied to industrial, extractive or primary production activities.[62]

Interest derived from loans granted by international agencies to foster Argentine economic development is exempted from the tax. This treatment is also applicable to loans granted by the International Finance Corpora-

tion, the Inter-American Investment Corporation and the Andean Development Corporation, among other international corporations and agencies.

#### (c) Transfer Pricing Rules

If the loan is executed between related parties or with an entity located in a jurisdiction of low or no taxation, the arm's length principle applies. That is, the loan should be executed under conditions similar to those which would be made between independent parties. Any payment exceeding the amounts that would have been agreed upon between independent parties is not deductible for the domestic company.

The determination of the arm's length compensation requires a case-by-case analysis, which includes the comparison of the agreement with similar agreements signed between independent parties. This analysis, and the background information that supports a certain amount of compensation between related parties, is shown in transfer pricing affidavits that should be prepared by independent accountants.

### 3. Value Added Tax

A value added tax, or VAT, is levied on sales and imports of goods, leases, works and performance of services except for those services performed in the country but with no effective use or exploitation in Argentina.[63] As for loans taken by the SPV to perform activities in Argentina, they are subject to taxation no matter where the money comes from.

A VAT is levied on the interest at either a 10.5 percent or twenty-one percent rate, depending on the loan characteristics. For example, the 10.5 percent rate may apply when the lender is a domestic financial entity or a financial institution located in a jurisdiction where standards of the Basel Committee on Banking Supervision apply.[64] In the case where the lender is a foreign entity, the performance of services is deemed an import and subject to tax as a consequence of the domestic use of the funds. The payment must be made by the domestic entity, which can later use this amount as a credit in assessing its VAT balance.

### 4. Personal Assets Tax and Minimum Presumptive Income Tax

Funding with a loan as opposed to a capital contribution diminishes the burden of the Personal Asset Tax on shares. The value of the shares is determined considering the difference between the assets and the liabilities. Therefore, by increasing liabilities the difference is smaller, which increases a correspondingly smaller tax base. Certain discussions have recently started on whether the credit itself is taxed with Personal Assets at a 1.25 percent rate. There is no conclusive position on the matter yet.

As for Minimum Presumptive Income Tax, the tax burden is the same regardless of whether a loan or a capital contribution is preferred. This is so because liabilities are not considered in determining the tax base.

### 5. Other Taxes

Taxes on debits and credits should also be considered, since there may be a difference between the taxation of capital contributions as opposed to loans. The credits on bank accounts are generally subject to a 0.6 percent tax. However, credits on current accounts arising from domestic bank loans are exempt from the tax.[65]

Also, domestic lenders are subject to a turnover tax on the interest. The tax rate varies from jurisdiction to jurisdiction and generally ranges from five to six percent.

### 6. Foreign Exchange Rules

Even when from a tax perspective a loan is generally more advantageous than a capital contribution, exchange rules applicable to loans may discourage the use of this type of funding. The foreign exchange control rules regulate the inflow and outflow of funds to and from Argentina and they establish a series of requirements and limits that apply to inflows and outflows. These requirements vary, depending upon, among other things, the kind of transaction to which the movement of funds is related, the provenance and destination of the money, and the assets involved.

In regard to loans, exchange rules establish a thirty-percent mandatory non-remunerated deposit on loans taken abroad.[66] The deposit is kept for 365 days. Certain loans are excluded from this treatment, such as, for example, loans taken by non-financial entities with an average life of at least two years, including capital and interest and that have been taken to invest in non-financial assets.[67]

## C. Private Bonds

Tradable bonds publicly offered have some tax incentives if the funds received through their sale are used (i) to invest in tangible assets located in Argentina, (ii) to generate working capital formation in Argentina, (iii) to refinance loans, or (iv) to achieve the consolidation of related entities' stock in order that the entities can use the funds to accomplish the transactions specified in the preceding (i) through (iii).[68]

These incentives are the following:

- Financial transactions related to the issuance, subscription, placement, transfer, amortization, payment of interest and cancelation of bonds and their guarantees are VAT exempted.
- Income derived from the sale, change, swap, conversion and disposition of bonds is exempted from

income tax. The exemption also applies to interest, inflation adjustments and capital adjustments.

- The issuer may fully deduct interest and inflation adjustments accrued as well as any cost and discount related to the issuance and placement. This benefit may not apply in the event the financial cost borne by the issuer is disproportionate to the typical cost in the market on similar risks and terms.

However, the restriction of the last two incentives solely to individuals makes this financial instrument not very attractive to investors organized as companies.[69] Additionally, formalities and obligations that must be fulfilled by companies that place the bonds may discourage the use of this tool.

## V. Tax Treatment

The Argentine tax regime falls into three categories: federal taxes; provincial taxes; and municipal taxes. The main taxes applicable to a domestic entity at a federal level are Income Tax (domestic entities are subject to a thirty-five percent rate), Value Added Tax (twenty-one percent or 10.5 percent rate, depending on the transaction), Minimum Presumptive Income Tax (one percent on the amount of the assets),[70] Personal Assets Tax (one-half percent on the shares; the domestic entity pays the tax under a substitution regime), and Tax on Bank Debits and Credits (0.6 percent on the bank debit or credit).[71] At a provincial level, the activity is taxed with Turnover Tax at a rate that varies, depending upon the jurisdiction in which the construction is performed. Turnover Tax rates for construction range between 1.5 percent and four percent.

Even when there is no promotional regime applicable to a construction project, there are specific rules for the assessment of the taxes. They are described below, based on the tasks of the project to which they correspond. Also, some tax benefits may be granted in the bidding documents.

### A. Income Tax

There is a special allocation rule for construction, which is also applicable to public works.[72] In general, income and expenditures must be allocated upon accrual. However, gross income generated by construction activities must be allocated according to one of the two following allocation methods:[73]

- **Margin over Payments**: Allocating to each tax period the gross income that results from multiplying the payments received during the period by the gross income margin estimated for the whole project.[74]
- **Work Completed**: Allocating to each tax period the gross income that results from adding all payments to be received for the work made during the tax period and deducting costs incurred to make them.

In both methods, (i) expenditures that have an indirect relation with the construction must be allocated to the tax year they accrued in, following the general rules of income tax;[75] and (ii) any difference that may result from comparing the gross income determined once the project is completed with the gross income previously estimated must be allocated to the year in which the project is completed.

In the case of public works compensated with a concession, the income to be received is very hard to determine before the work is completed and the exploitation initiated. For this reason scholars consider that the income should be declared in the exploitation period and with the first method specified above, that is, taking into account the payments received in each period. Since the work is wholly completed, it is not possible to apply the second method, outlined above.[76] For adjusting the estimate with the income of the concessionaire, the length of the project is considered to include the exploitation period.[77]

The AFIP has stated that, if the income derived from the construction activities can be differentiated from the income derived from the exploitation, the treatment described above may only apply to the income derived from construction activities.[78]

Since Highways, Inc. is not the owner of the project, it cannot depreciate the construction. This depreciation may only be made by the owner of the construction. Costs generated by the construction are not the acquisition price of an asset but an investment for obtaining the exploitation of the bridge.[79] Nevertheless, fixed assets bought to perform construction and maintenance activities can be depreciated. The useful life to be considered must be determined on the base of technical and factual aspects and may or may not be equal to the length of the concession.[80]

### B. Value Added Tax

In the case of construction activities on a third party's property, VAT debits are generated when (i) the certificate of work completion is partially or totally accepted, (ii) the price is partially or totally paid, or (iii) the invoice is issued, whichever comes first.

Conversely, if the construction activities are compensated with an exploitation concession, VAT debits are generated when revenues (as tolls) are received.[81]

### C. Social Security

Employees and employers must pay social security contributions. In both cases the contributions are calculated as a percentage on salaries, regular bonuses and some incentives paid to employees, within certain limits (caps and minimum amounts). Employers that are Small

and Medium Enterprises and employers whose main activity is not commerce or provision of services (such as construction entities) pay a reduced amount of contributions.[82] The comparison of contributions is shown in the following chart.

| CONCEPT | EMPLOYER CONTRIBUTION | |
|---|---|---|
| | Employers that are not PYMEs*and employers whose main activity is commerce or provision of services | Other employers, such as construction enterprises |
| SIPA** | 12.71% | 10.17% |
| Family Allowance | 5.56% | 4.44% |
| National Employment Fund | 1.11% | 0.89% |
| INSSJP*** | 1.62% | 1.5% |
| Health Insurance | 6% | 6% |
| **TOTAL** | **27%** | **23%** |

* Small and Medium Enterprises (PYMEs, as per its acronym in Spanish)

** Integrated Social Security System (SIPA, as per its acronym in Spanish)

*** National Department of Social Services for Retired Persons (INSSJP, as per its acronym in Spanish).

## VI. Equipment

If Highways, Inc. needs equipment to build the highway, the first issue to deal with is whether Highways, Inc. needs to buy the assets.

From a tax efficient standpoint (and independently of availability and prices in the domestic and international market), if Highways, Inc. only needs the equipment for a limited period of time, a lease may be the best option. However, it should be noted that used capital equipment cannot be definitively imported without a prior authorization of the Administration and such an import would be subject to certain conditions. The suspensive import can be prohibited, depending on the tariff item number of the equipment involved.[83] Also, it should be noted that public concessionaires are subject to the Buy Argentinean Act[84] and will grant a preference for Argentine goods in their leases and purchases.[85] As in the case of the Contract Domestic Laws, the compatibility of this kind of law with the compromises undertaken by Argentina at the international level—especially the standard of national treatment—is beyond the scope of this analysis.[86] Nonetheless, it should be noted that the BIT executed between Argentina and the United States specifically states that "[n]either party shall impose performance requirements as a condition of establishment, expansion or maintenance of investments, which require or enforce commitments to export goods produced or which *specify that goods or services must be purchased locally*, or which impose any other similar requirements."[87]

Also, in the case of complete lines of businesses there is a promotional regime that may apply to reduce or eliminate taxation.[88] The regime is available for imports of new and used lines.

### A. If the Equipment Is to Be Bought

If the equipment is to be bought, then the equipment can be acquired in the local market. The price will include VAT at 10.5 percent or twenty-one percent depending on the asset involved,[89] and, eventually, excise taxes. The seller, resident in Argentina, will be subject to Turnover Tax and Income Tax.

Alternatively, the equipment can be acquired abroad and imported, subject to the Buy Argentinian Act. In Argentina, customs regimes for imports fall into two main categories, which are as follows.

- *Definite Importation,* which allows the equipment to circulate freely in Argentina for an indefinite period of time. Import duties are paid on the equipment when it is imported and if there is an export, it will also be charged with export duties. The definite importation can be accomplished by paying the following taxes:
  - Value Added Tax: 10.5 percent or twenty-one percent, depending on the asset involved. A five-percent advanced payment is also required.
  - Import Duties: about fourteen percent for machines used in constructing activities, depending on the asset involved and whether it is new or used.[90]
  - Excise Taxes: 20.48 percent in the event excise taxes are levied on the asset imported. This rate applies to a tax base equal to the customs value of the products increased by the import duties and multiplied by 1.3.

Non-resident aliens are subject to the Argentine Income Tax only in the event the source of the income they receive is Argentine. Therefore, the payment made to the non-resident alien will not be subject to Income Tax, since the source of the income derived from the sale is deemed foreign source income. Nor does the Turnover Tax apply, since the seller is not performing regular activities inside Argentina.

On a subsequent export, the following taxes apply:

- Value Added Tax: 0%. VAT does not apply to exports, and reimbursement of VAT credits paid to acquire the equipment can be requested.

– Export Duties: about five percent, depending on the asset involved.

- *Suspensive Importation,* which limits the circulation of the equipment and/or the period the equipment may stay in Argentina. When the term expires, the equipment must be exported. This suspensive importation is in turn divided into three categories:

  – *Suspensive Importation for Transit,* which allows the equipment to only circulate inside Argentina.

  – *Suspensive Importation for Warehousing*, which allows the equipment to stay in a fiscal deposit.

  – *Suspensive Temporary Importation,* which allow the equipment to stay in Argentina for a certain period and for a specific use. The importer cannot be the owner of the equipment. This means that only a definite destination can be used if the equipment is bought and imported.

### B. If the Equipment Is to Be Rented

The equipment can be rented in the local market. Rents will include VAT at 10.5 percent or twenty-one percent depending on the asset involved.[91] The lender is to include the payments in the lender's annual Income Tax assessment.

Alternatively, the equipment can be rented abroad and imported, subject to the Buy Argentinean Act. A suspensive temporary importation can be arranged if: (i) Highways, Inc. does not need the equipment for a period longer than three years;[92] and (ii) the specific use is legally allowed.[93]

Neither import duties nor VAT are applicable on suspensive imports. However, the importer must guarantee the value of import duties that would have to be paid in the event the suspensive temporary importation becomes a definite importation.

Non-resident aliens renting assets in Argentina are subject to VAT, but there are some difficulties in registering the non-resident alien before AFIP, which results in this payment not being made in some cases.[94] The same criterion applies to the Turnover Tax. As for the Income Tax, payments will be subject to withholding at thirty-five percent on the forty percent of the payment (which is the percentage presumed to be income). The Income Tax rate may vary in the event a DTT applies to the relationship between lender and payor.

Apart from taxes, if the SPV is funded with credits of a development bank, there can be restrictions on where the assets may be acquired. Commonly, these banks set certain restrictions on the place of purchases or leases to grant credits to make such acquisitions possible. For example, the Export-Import Bank of the United States (Ex-Im Bank) only assists in financing acquisitions of U.S. goods and services.[95]

## VII. Cross Border Services

As mentioned before, income tax is imposed on non-resident aliens without a permanent establishment in Argentina only in regard to that portion of their income whose source is Argentine. The income tax is withheld at a thirty-five percent rate on the portion of the payments presumed to be income. This rate may vary if a treaty for the avoidance of double taxation applies.

In the event a non-resident alien has a permanent establishment, the permanent establishment is taxed as if it were a domestic corporation.

Therefore, in order to give a better idea on what would be the treatment of the cross border services rendered by Highways, Inc., it should be determined (i) whether the service is provided from abroad, (ii) if the foreign entity provides services through a permanent establishment located in Argentina, and (iii) which type of service is involved. Aspects (i) through (iii), among other things, are crucial to know: (i) the source of the income received by the foreign entity; (ii) if the entity that renders the services is subject to tax as a non-resident entity or under the general tax regime; (iii) the portion of the payment presumed to be income (and therefore subject to the thirty-five percent rate) if the foreign entity does not operate through a permanent establishment; (iv) the portion of the payment that the domestic payor can deduct; (v) how to apply transfer pricing rules; (vi) if VAT is levied on the service; and (vii) if personnel will be temporarily assigned to Argentina.

### A. Source of the Income

Additionally to specific provisions of the Income Tax Law, the Argentine source income category includes income derived from (i) assets located, placed or used in Argentina; (ii) services or acts performed in Argentina; and (iii) facts that took place in Argentina.[96]

As for services, the Argentine source income category encompasses the income only if the service is rendered in Argentina. However, income derived from consultancy activities for the benefit of an Argentine company is considered to be Argentine source income, even if the service is rendered from abroad.[97] Whether the service is a consultancy activity or not will therefore be a key aspect in regard to locating the source of the income.

This understanding is shared by scholars,[98] but there is some recent jurisprudence that has considered that the source of the income derived from services rendered by foreign entities in relation to activities performed in Argentina by a domestic entity is Argentine. The ground for saying that was that Argentina was the place of use of the service.[99]

### B. Applicable Tax Regime

As previously mentioned, foreign entities are subject to tax on their Argentine source income. This tax is paid through a withholding regime.

Conversely, the general tax regime applies if the foreign entity has a permanent establishment in Argentina. If this is the case, the permanent establishment must register with the AFIP and be assessed income tax annually. Whether a permanent establishment exists depends, among other aspects, on the length of time in Argentina and the corporate purpose of the entity and the activities performed within Argentina. If the foreign entity is located in a country that has executed a DTT with Argentina, the permanent establishment definition contained therein will prevail.

### C. Taxable Income

In case the withholding regime applies, the nature of the service will determine what is the taxable income. This issue is only relevant in case the source of the income is deemed of Argentine origin.

The withholding rate is thirty-five percent and the tax base, which is determined by the legally presumed income in each case, varies between sixty percent and ninety percent, depending upon the service involved and whether the agreement was registered with the Technology Transfer Office (INPI, as per its acronym in Spanish), if such registration is required.

Such a registration must be made if the service qualifies as technical assistance, which is determined by the following criteria:

- The technical assistance follows prudent engineering practices.
- The technical assistance is provided as an intellectual work or service.
- The technical assistance is remunerated in relation to the length or the amount of the work.
- The technical assistance providers undertake the obligation of including a technical knowledge directly applicable to the business performed in Argentina by the domestic entity.

Notwithstanding the previous analysis, the domestic tax may be reduced if a DTT executed with Argentina applies. But there is no DTT with the United States and, therefore, the general aspects previously described apply if Highways, Inc. is the service provider.

On the other hand, if the service is rendered by a subsidiary of Highways, Inc., a DTT may apply and diminish or eliminate the burden of the tax. The tax may be diminished, for example, if the service provided falls within the concept of royalty included in the relevant DTT. The Argentine tax may not apply in case the income received by the foreign entity is considered as a business profit and the entity does not have a permanent establishment in Argentina. Courts have not yet decided which is the classification of services in DTTs when the royalties article does not apply. Generally, scholars understand that the business profits article rules in that case.

In the case of permanent establishments, the service provider will be assessed a tax annually, which shall apply at a thirty-five percent rate on the tax base.

### D. Deductibility

#### 1. Generally

The payments will be deducted as expenditures or depreciated as an investment, depending on the nature of the service. Also, domestic Specific Anti-Avoidance Rules (SAARs) limiting the deduction of certain expenditures may apply. The most important of these limitations is the one applicable to consultancy.

To analyze if the full deduction of payments is allowed, the following general aspects must be considered:

- Commissions and expenditures incurred abroad are deductible if they are fair and reasonable.
- The compensation paid by the domestic company must be similar to the compensation that might have been agreed between independent parties, under the arm's length principle.
- Commissions and expenditures must be paid in compensation for services effectively rendered and useful for the activity performed by the SPV.
- No deduction can be made in the event the registration of the agreement with the INTI was not made, when such registration is required.

For deducting the cost and expenditures, the SPV must have documentation that evidences that the services rendered are related to and for the benefit of the Argentine company. Also, the Argentine company must receive invoices with a breakdown of each service hired and its price. Fees should not be calculated as a result of mathematical allocations with no support.

Courts are quite restrictive in regard to the admission of deductions of generic expenditures encompassed in a unique accounting entry. They have required that the expenditures be real, reasonable and necessary for the local company in order to obtain, maintain and keep its income.[100]

Specifically, courts understood that if the guidelines followed by the headquarters to distribute expenditures among different subsidiaries were not specified, the nature of the expenditures could not be determined. The lack of certainty in the specific nature of the expenditures

prevented the courts from identifying whether the expenditures were necessary for the local activities of the domestic company or were made in view of the headquarters' interest to keep its investment safe. Neither the reasonableness of the expenditures nor the necessity to incur them could be examined under these circumstances and led courts to disallow deductions claimed by domestic companies.[101]

### 2. Limitation of Deductions: Consultancy

A service is characterized as consultancy if it is intended to transfer scientific or empiric knowledge to be used in the performance of economic activities in Argentina.[102] In these cases, the following limits of deductions apply when the service is rendered from abroad:

- Three percent of sales of revenues that are used in the calculation of the consideration paid for the technical assistance.
- Five percent of the amount of the investment made pursuant to such assistance.

These limits may not apply if the payments were made to an entity residing in a country that has executed a DTT with Argentina. However, not every Argentine DTT restricts the application of this SAAR. That is true only in the case of DTTs with non-discrimination clauses which say that disbursements paid by an enterprise of a contracting state to a resident of the other contracting state shall be deducted under the same conditions as if they had been paid to a resident of the first-mentioned state.[103]

## E. Transfer Pricing

For income tax purposes, agreements executed between related parties should follow the arm's length principle, *i.e.*, they are to be negotiated and be executed under conditions similar to those which would be made between independent parties. Any payment made exceeding the amounts that would have been agreed between independent parties is not deductible for the domestic company.

The determination of what constitutes arm's length compensation requires a case-by-case analysis, which includes a comparison of the agreement with similar agreements signed between independent parties. This analysis, and the background information that supports a certain amount of compensation between related parties, is to be shown in transfer pricing affidavits that should be prepared by independent accountants.

## F. VAT

VAT is levied on the so-called "imports of services" at a 10.5 percent or twenty-one percent rate, depending on the case. Such imports are deemed to exist if (i) such services are provided abroad; (ii) the effective use or exploitation of the services takes place in Argentina; and (iii) the persons receiving the services are VAT taxpayers as a consequence of other taxable events and are enrolled under VAT.

Although there is no legal definition of "effective use or exploitation," the AFIP considers that effective use or exploitation of the services in Argentina exists when, for instance, the service provided abroad by a foreign company is incorporated into the activity that a domestic company develops in Argentina.[104] The AFIP has also stated that the software adapting services provided by a foreign company were effectively used in Argentina because they were hired by a domestic company for the activities the latter performed in Argentina.[105]

Additionally, in a case related to export of services, the Tax Court has decided that, given that there was no activity developed in Argentina by the foreign companies, the service was effectively used abroad.[106]

Since the SPV will use the services in order to carry out its construction and maintenance activities, these services will be within the scope of VAT and subject to a twenty-one percent tax rate.

The SPV must pay this tax within ten business days after the completion of the service or the total or partial payment for the service, whichever occurs first. The following month, the Argentine company will credit this payment in its VAT account.

## G. Temporary Employment

Income derived from services rendered in Argentina is considered Argentine source income. Therefore, the income is subject to tax in Argentina even if the recipient is a non-resident person.

As mentioned above, non-resident persons generally pay this tax under a withholding regime. For temporary employments, the portion of the payments presumed income is seventy percent for workers that stay in the country for six months or less, and ninety percent when the stay is longer. Therefore, the withholding rates are 24.5 percent (thirty-five percent of seventy percent) and 31.5 percent (thirty-five percent of ninety percent), respectively.

Foreign non-resident aliens that reside in Argentina for work-related reasons for up to five years are not considered Argentine tax residents. Even when they are not Argentine residents, they must pay the tax on their Argentine source income under the general tax regime.[107]

## Endnotes

1. Law 19,550 ("Argentine Corporation Law"), Section 118, §1. Nevertheless, foreign companies are deemed domestic in regard to supervision and formalities of incorporation if they have their corporate seat in Argentina or their main corporate purpose is meant to be carried out in Argentina. Id., Section 124.
2. Argentine Corporation Law, Section 118, §2-3.
3. Argentine Corporation Law, Sections 118, §3; 377, §2.
4. General Bidding Conditions for Bidding and Contracting Public Works, Section 10, of the Agency for the Control of Public Thoroughfare Concessions (OCCOVI, as per its acronym in Spanish).
5. Order 16/04 of the Presidency of the Cabinet of Ministers.
6. Decree 756/81, Section 30. See also, *e.g.*, OCCOVI Bidding Document for the Highway Corridor No. 5, particular Conditions, available at http://www.occovi.gov.ar/concesiones/pdf/2do_llamado/PByCP_CV5.pdf (15 Sept. 2011).
7. *See*, *e.g.*, ENARSA Bidding Document No. EE May/2011, available at http://www.enarsa.com.ar/pdf/licitacion_2011_EE05_pliegoBYC.pdf (13 Sept. 2011).
8. See Decree 436/00, Section 34. Also, establishing a subsidiary may be required in this type of bidding process. *See*, *e.g.,* Lotería Nacional Bidding Document 4/2009, available at http://comprasestatales.com/att/filex4GDD3.doc (13 Sept. 2011).
9. Law 18,875, Section 1.
10. *See*, *e.g.*, ENARSA Bidding Document no GJA-001/2010, Section 2.2 ("Compre Trabajo Argentino"), available at http://www.enarsa.com.ar/pdf/licitacion_2010_GJA01_pliego.pdf (15 Sept. 2011).
11. See BIT executed between Argentina and United States on 14 Nov. 1091, Article II; Protocol of Colonia executed among the members of the MERCOSUR on 17 Jan. 1994, Article 2; Javier Illescas, *Los tratados de protección de inversiones y su utilidad para los inversores españoles en Latinoamérica*, Section 2.3 ("Los estándares de tratamiento de tipo relativo"), available at http://www.uria.com/documentos/publicaciones/1056/documento/07Illescas.pdf?id=2016 (15 Sept. 2011); *ADF Group Inc. and United States of America*, Case no ARB(AF)/00/1, Award dated 9 Jan. 2003, on Buy National Laws, among others.
12. There is no specific definition of "joint venture." A UTE may or may not be considered a joint venture, depending on the definition adopted. For the purposes of this article, a joint venture is defined as a business undertaken by two or more enterprises with the purpose of carrying out a determined project no matter whether registration or formalities are required.
13. *See*, *e.g.*, Lotería Nacional Bidding Document 4/2009, Test Matrix, available at http://comprasestatales.com/att/filex4GDD3.doc (13 Sept. 2011).
14. Some of these reasons are: (i) a new SPV cannot use VAT credits generated by the previous vehicle unless a reorganization process takes place; (ii) a new SPV cannot use Minimum Presumptive Income Tax payments as Income Tax advanced payments unless a reorganization process takes place; (iii) corporate registration fees must be paid again to register the new SPV; (iv) a time-consuming registration process must be carried out twice. The reasons listed above in (i) and (ii) do not apply to conversions from one corporate form to another, while the registration fees mentioned in (iii) and the administrative process mentioned in (iv) must be paid and completed.
15. OCCOVI General Bidding Conditions for Bidding and Contracting Public Works, Section 39.
16. The Argentine Corporation Law establishes that UTEs are not legal entities. Some authors have raised certain objections. See Mariano Esper, Uniones Transitorias de Empresas 115-137(2006).
17. Law 20,631 ("Value Added Tax Law"), Section 4, §2.
18. See 2011 Tax Code of the City of Buenos Aires, Section 136; 2011 Tax Code of the Province of Buenos Aires, Section 19; Opinions 85/07 and 174/06, Technical Tax Department of the Tax Administration of the Province of Buenos Aires.
19. *See*, *e.g.*, Resolution 830/00 of the Argentine Tax Authority ("AFIP," as per its acronym in Spanish), Annex IV.
20. Argentine Corporation Law, Section 377, §1.
21. All members of the UTE must qualify as domestic companies in order to participate in the bidding process to which the Contract Domestic Laws apply. See Resolution 284/05 of the Secretariat of Industry, Commerce and Small and Medium Enterprises. *See also*, *e.g.*, ENARSA Bidding Document no GJA-001/2010, Section 2.2, available at http://www.enarsa.com.ar/pdf/licitacion_2010_GJA01_pliego.pdf (15 Sept. 2011).
22. Discussions are based on the absence of specific rules on liquidation applicable to UTEs. On this discussion, *see*, *e.g.*, National Court of Commerce, "Cotecar SRL," Chamber A, 14 Nov. 1997; Enrique Zaldivar *et al.*, Contratos de Colaboración Empresaria 238 (1997); Ricardo A. Nissen, Curso de Derecho Secretario, 604-605 (2003); Mariano Esper, Uniones Transitorias de Empresas 241-242 (2006).
23. Argentine Corporation Law, Section 379.
24. *Id.*
25. Against this understanding, see Sergio Le Pera, Joint Venture y Sociedad 166-170 (1997).
26. This limited liability is understood to cover contractual obligations with certain exceptions such as on labor law. Mariano Esper, Uniones Transitorias de Empresas 249 (2006).
27. OCCOVI General Bidding Conditions for Bidding and Contracting Public Works, Section 14.
28. Law 11,683, Section 8, Subsection (g).
29. For example, whereas in a stock company partners cannot balance the entity's profits with their losses, in a UTE structure they can. Also, there may be a difference in favor of a UTE structure in the event the members are not corporations, since the results of the activity would be subject to a gradually increasing rate ranging from nine to thirty-five percent (stock companies are subject to a non-gradual thirty-five percent rate). Notwithstanding, if the members are stock companies, the results will be subject to a thirty-five percent rate.
30. Law 20,091, Section 30.
31. Law 21,526, Section 13.
32. In order not to apply the mandatory deposit described in Part IV below, banks require proof that the money flows into the country as a capital assignment and not as a loan. Also, when remittances are made, the Tax Administration may require proof of the character of the money which is transferred.
33. This requirement is even stricter than the rules on capital of subsidiaries. Resolution 11/06 of the Superintendence of Corporations, applicable to entities registered in the City of Buenos Aires. Superintendences of Corporations are established at a provincial level and their rules vary from jurisdiction to jurisdiction.
34. Resolution 11/06 of the Superintendence of Corporations, applicable to entities registered in the City of Buenos Aires.
35. Local creditors are defined as such of the creditors whose claims must be paid in Argentina regardless of their nationality and domicile. Pablo D. Heredia, 1 Tratado Exegético de Derecho Concursal 293-295 (2000).
36. Gracey, *La asignación de capital a una sucursal de sociedad extranjera*, paper submitted to the VI Argentine Congress of Corporate Law and II Ibero-American Congress of Corporate

and Law of Enterprises, in 2 Derecho Societario Argentino e Iberoamericano 513 (1995). However, scholars consider that liability may be limited as per the *lex societatis*, such as under the Italian regime established in 2003. See Horacio Roitman, 2 Ley de Sociedades Comerciales: Comentada y Anotada 800 (2006).

37. *See*, *e.g.*, Law 20,628 ("Income Tax Law"), Section 69; Law 23,349 ("VAT Law"), Section 4; Law 25,063, Section 2, Law 23,966, Unnumbered Section following Section 20.

38. Decree 2284/91, Section 78.

39. Argentine Corporation Law, Section 1.

40. Argentine Corporation Law, Sections 146 and 163. On extension of liability in the liquidation process, see Ricardo A. Nissen, Curso de Derecho Societario 203-204 (2003).

    As an alternative, a *de facto* limited partnership ("*sociedad accidental o en participación*") may be used. *De facto* partnerships are temporary partnerships without legal capacity created for a certain number of transactions. Their acts are carried out through a manager partner that acts in its name. This type of association is not very common, since domestic stock corporations cannot take part in them. Argentine Corporation Law, Section 30. On the other hand, stock corporations can participate in UTEs, which was one of the reasons for the inclusion of UTEs in the Argentine legal framework. See Ricardo A. Nissen, Curso de Derecho Societario 321 (2003); Mariano Esper, Uniones Transitorias de Empresas 78-85 (2006); *id.*, Foreword by Ricardo A. Nissen; Horacio Roitman, 2 Ley de Sociedades Comerciales: Comentada y Anotada 807-810 (2006). Another difference between the two types of structures is that in a *de facto* partnership there is no legal representative: the partner acts before third parties in its own name. Also, *de facto* partnerships do not register with the Office of Corporations. Argentine Corporation Law, Sections 361-363.

    Another business structure recently included in the Argentine legal framework instead of constituting a UTE is the Cooperation Consortium. However, this arrangement is not dealt with in this article, since persons and foreign entities (such as Highways, Inc.), without a domicile or incorporation in Argentina, cannot participate in them. See Law 26,005.

41. *See*, *e.g.*, Order No. 4 issued in relation to the bidding process initiated by Resolution 82/06 of the Secretariat of Transportation, available at http://www.transporte.gov.ar/UserFiles/pdfs/licitaciones/sarmiento/circular4.pdf (14 Sept. 2011).

42. Argentine Corporation Law, Section 123. A minimum of two shareholders is required. Argentine Corporation Law, Section 1.

43. However, Argentina and the United States executed an agreement to avoid double taxation on international transportation on 30 December 1987.

44. The Double Taxation Treaty executed between Argentina and USA in 1981 has not been ratified and therefore it has never entered into force. Even if not directly changing the tax burden of United States investments in Argentina, tax-related clauses provided for in the BIT executed between Argentina and United States in 1991 may be relevant because of the type and duration of the project to be developed.

45. This treatment is also applicable to cases of liquidation and redemption of stock. Decree 1344/98, Unnumbered Section following Section 102, §4.

46. Income Tax Law, Sections 46, 64, Unnumbered Section following Section 69.

47. Taxable profits included in this calculation are profits accumulated at the end of the last fiscal period, adjusted by (i) the income tax paid in relation to the year such income was generated and (ii) dividends received by the entity that were not taxable income in such fiscal periods.

48. *See*, *e.g.*, DTT executed between Argentina and Spain, Article 10; DTT executed between Argentina and the United Kingdom, Article 10; DTT executed between Argentina and The Netherlands, Article 10.

49. The concept of "effective beneficiary" is not expressly included in all DTTs executed by Argentina. It is included, for example, as Article 10(4) of the DTT executed between Argentina and Spain and Article 10(6) of the DTT executed between Argentina and The Netherlands, with certain exemptions. However, if the concept is not included in the treaty and the shareholder is not the effective beneficiary of the dividends, the applicability of domestic General Anti-Avoidance Rules ("GAARs") in the DTT context may become relevant. See Memorandum 64/09 of the National Tax Department.

50. Decree 2284/91.

51. As far as relevant, the Minimum Presumptive Income Tax is levied on assets of legal entities domiciled in Argentina. The tax is paid annually and the tax rate is one percent on the asset value, disregarding the entity's liabilities. As for the Personal Assets Tax, the substitution regime described in Part IV applies on the proportional equity value of the relevant interests, which makes liabilities relevant for the calculation of the charge.

52. Cheryl V. Reicin *et al.*, An Insider's Guide to Going Public 4 (2002).

53. *Id*. at 4-5.

54. See Decree 677/01 and regulatory standards established by the National Security Commission (CNV, as per its acronym in Spanish); Cheryl V. Reicin *et al.*, note 52 *supra*, at 5-8.

55. See Opinions 40/79 and 3/83, National Tax Authority. See also Law 20,551, restricting benefits on capital investments in mining activities for certain preferred stock.

56. These authors base their argument on the non-discrimination article contained in all DTTs executed by Argentina. See Carlos Casanovas and Gustavo Scravaglieri, *Aspectos controvertidos en los Convenios para Evitar la Doble Imposición Internacional y la cláusula de no discriminación*, 27 Práctica Profesional 27 (2006).

57. See Part IV.B.2(b), "Income Tax on Interests."

58. The interest is not deductible in the proportion that corresponds to the amount of liabilities on which they accrue if that exceeds two times the net equity.

59. See, *e.g.*, the DTTs that Argentina has executed with Denmark, Finland, and Spain, which allow the application of domestic specific anti-avoidance rule on thin capitalization.

60. The National Tax Department considered the domestic GAAR applicable in treaty contexts even if such application was not envisaged in the treaty drafting. See Memorandum 64/09, National Tax Department. Also, understanding that domestic SAARs are not applicable whenever not mentioned in the DTT ran contrary to DTT articles that expressly disallow the use of a certain SAAR, whose application in the treaty context was not previously allowed. *See*, *e.g.*, the DTTs that Argentina executed with Denmark, Finland and Spain.

61. See Opinions 52/06 and 96/07, AFIP Technical Tax Department, Opinion 72/97, AFIP Legal Tax Department, etc.

62. Decree 1348/98, Section 145.

63. VAT Law, Section 1.

64. VAT Law, Section 28, §4, d).

65. Decree 380/01, Section 10, Subsection i).

66. Decree 616/05.

67. Communicate A 4377 of the Central Bank of Argentina.

68. Law 23,576.

69. Decree 1076/92.

70. Under certain circumstances, this tax can be credited against income tax.

71. The tax also applies to some transactions in which either the use of bank accounts is avoided or a financial entity takes part. In these cases the rate is 1.2 percent. This tax can be partially compensated with the payment of other taxes, such as the Minimum Presumptive Income Tax and the Income Tax.

72. External Note 3/1998, AFIP. There are special rules for projects developed in less than one fiscal year and for public works paid on installments due once the project is finished.

73. The text of the Income Tax Law does not define the "gross income" concept. Scholars have understood that the gross income is the result from deducting direct costs to the work total price. Armando Lorenzo *et al.*, TRATADO DEL IMPUESTO A LAS GANANCIAS 383 (2005); Carlos A. Raimondi and Adolfo Atchabahian, EL IMPUESTO A LAS GANANCIAS 505 (2007).

    The use of constant currency or current costs for the calculation is not stated in the law either.

74. This is the most commonly used method, since it defers the tax until the moment payments are received. However, the statute of limitations applicable to loss carryforwards (five years) must be considered when deferring the tax. Osvaldo Balán and Osvaldo M. Zilli, *Las empresas de construcción y el artículo 74 de la ley de ganancias*, PRÁCTICA PROFESIONAL, 12 Aug. 2011.

75. As noted above, the Income Tax Law does not define the "gross income" concept. See note 73, *supra.*

76. It was understood that the following steps must be followed for applying the first method in these specific cases: (i) estimate the revenue that will be derived from the project; (ii) estimate the income by deducting the estimate of total costs; (iii) determine the ratio between income and revenue; (iv) apply such ratio to the payment received during the period; and (v) deduct the expenditures incurred during the period. Luis O. Fernández, EL IMPUESTO A LAS GANANCIAS 738 (2005).

77. See Opinion 210/96, AFIP Legal Tax Department.

78. This differentiation is not generally possible. Opinion 210/96, AFIP Legal Tax Department.

79. Opinion 210/96, AFIP Legal Tax Department; Luis O. Fernández, EL IMPUESTO A LAS GANANCIAS 737 (2005).

80. See Argentine Supreme Court, *Oleoductos del Valle S.A.* (TF 19.260 - I) c. DGI, 16 Feb. 2010.

81. VAT Law, Section 23; Opinions 40/99 and 59/03, AFIP Technical Tax Department.

82. See Decrees 814/01 and 1009/01.

83. Resolution 909/94 of the Minister of Economy.

84. Law 25,551.

85. Preference will be given to Argentine products if the price of the Argentinean products is lower than the price of the foreign products increased by seven percent (if the domestic seller is a Small and Medium Size Enterprises) or five percent (in all other cases). See Law 25,551, Section 3.

86. See BIT executed between Argentina and United States on 14 Nov. 1991, Article II; Protocol of Colonia executed among the members of the MERCOSUR on 17 Jan. 1994, Article 2; Javier Illescas, *Los tratados de protección de inversiones y su utilidad para los inversores españoles en Latinoamérica*, Section 2.3 (*Los estándares de tratamiento de tipo relativo*), available at http://www.uria.com/documentos/publicaciones/1056/documento/07Illescas.pdf?id=2016 (15 Sept. 2011); *ADF Group Inc. and United States of America*, Case no ARB(AF)/00/1, Award dated 9 Jan. 2003; Agustín Crivelli, *Liberalización de las compras y contrataciones públicas: freno a las políticas nacionales de desarrollo. El caso argentino*, available at http://bibliotecavirtual.clacso.org.ar/ar/libros/becas/2005/alcajov/crivelli.pdf; among others.

87. BIT executed between Argentina and United States on 14 Nov. 1991, Article II(5). Emphasis added.

88. Resolutions 256/00 and 511/00 of the Ministry of Economy.

89. Generally, equipment is subject to a 10.5% rate. This is the case, for example, for road rollers [tariff item number (NCM) 8429.40.00.000K], milling machines [tariff item number (NCM) 8465.92.11.000F], etc.

90. Imports of capital equipment are exempted from statistical duties. Decree 690/02, Section 26, Subsection g).

91. Generally, equipment is subject to a 10.5 percent rate. This is the case, for example, for road rollers [tariff item number (NCM) 8429.40.00.000K] and milling machines [tariff item number (NCM) 8465.92.11.000F.

92. Customs Code, Section 265.

93. Such as being incorporated in an economic process. Decree 1001/82, Section 31, Subsection 1, §a.

94. See Minutes of 14 March 2011 AFIP – Professional Council of Economic Sciences Meeting, available at http://www.consejo.org.ar/impuestos/genlade/genlade01/enlace_1403.htm (4 Nov. 2011)

95. See http://www.exim.gov/about/mission.cfm (16 Sept. 2011).

96. Income Tax Law, Section 5.

97. Income Tax Law, Section 12.

98. Luis O. Fernández, EL IMPUESTO A LAS GANANCIAS 210-211 (2005).

99. See Tax Court, *Union Pak SA*, Chamber B, 6 Jul. 2010. In this case, one of the members of the court considered applicable "a sort of hypo of extension of the source principle based on the economic use of the service" (Ms. Adorno's vote). See also *Aerolíneas Argentinas SA*, National Court on Administrative Law Matters, Chamber I, 5 Feb. 2008.

100. *First National City Bank*, National Court of Appeals on Administrative Law Matters, Chamber II, 13 Sept. 1979.

101. *Citibank NA*, National Court of Appeals on Administrative Law Matters, Chamber I, 8 Aug. 1985.

102. Opinions 40/96 and 103/96, AFIP Technical Tax Department.

103. *See, e.g.*, DTT executed between Argentina and France, 4 April 1979, Article 25.

104. Opinion 7/06, AFIP Technical Tax Department.

105. Opinion 35/02, AFIP Technical Tax Department.

106. *Tecnopel SA*, Tax Court, Chamber A, 12 June 1999.

107. There are different understandings of when this regime should apply: either upon the first payment to the non-resident persons is made or after the first six months that the non-resident persons dwell in Argentina.

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# Utilizing Tax Incentives for Infrastructure Ventures in Latin America: The Brazilian Perspective

By Tatiana S. O. Falcão

## I. Introduction

This article discusses tax planning options for Highways, Inc. to start doing business in Brazil and, from Brazil, perhaps also in other Latin American countries. Prior to that discussion, it is important to focus some attention on the interesting political, social and economic period that Brazil is currently experiencing. Brazil has enjoyed record growth for the past eight years. The country was hardly affected by the 2008–2009 world crisis and is facing only mild repercussions from the current 2011 recession. Much of Brazil's growth derives from internal consumption. One of the past Administration's greatest triumphs was granting a stimulus (through money injections marketed as a social program called the family scholarship or "*bolsa familia*") for the lower classes to consume and hence ascend socially to what is being referred to as the new Brazilian middle class.

The newly acquired buying power of the lower classes allowed the economy to grow on internal consumption, hence diminishing the effects of the global crisis. For the first time in Brazilian history, the country was not entirely dependent on the exportation of commodities, allowing the country to run its own individual path, alien to the effects of the world economy. Other policies, which had begun long before President Lula's administration, also contributed to the favorable scenario: (i) for the first time, Brazil had enough international currency reserves to protect the national currency (the Real) from dollar fluctuations; (ii) sound monetary and inflationary policies had been ongoing since 1994, and President Lula upheld those policies; (iii) Brazil managed to honor and hence extinguish its debt with the International Monetary Fund; and (iv) the Brazilian foreign policy diplomatic body (often referred to as "Itamaraty," after the palace that houses the Ministry of Foreign Affairs) made a leap into the world's spotlight, shifting its role—from that of a mere spectator to that of a major player in international relations.

Perhaps because of this stable economic background, Brazil was chosen to host two of the biggest sports events in the upcoming decade. In 2014, Brazil will host the FIFA Soccer World Cup and, in 2016, Rio de Janeiro will host the Olympics. Brazil's current reality contrasts deeply with the crisis scenario that the rest of the world is facing. Although the country is not bound to be immune forever, it is unlikely for it to experience the full effects of the crisis before 2016. With most of the developed world experiencing negative growth, businesses are fleeing to Brazil to profit from some the boom derived from the major infrastructure investments that are being made in many of the main Brazilian cities.

The world has been kind to Brazil, but Brazil has also been kind to foreign businesses. As will be seen throughout this article, one of the biggest disincentives to invest in Brazil is the complex tax system. Several Brazilian taxes are based on a cascading system, causing the overall tax burden on a business (among federal, state and municipal taxes) to sometimes be as high as 33.4%.[1] To put this number into perspective, it is important to note that a mean OECD country (i.e., a developed country) carries an overall gross tax rate of 35.1%, only slightly above the Brazilian average.[2] Additionally, most of the heavy taxation is levied on goods and services, accounting overall for 47.36% of the taxes levied by the government.[3] As will be seen below, the cascading system is to blame for the high tax yield on goods and services, since it causes some taxes to integrate or incorporate the taxable basis of other taxes, hence increasing the effective tax burden of a transaction.

In order to counter that effect and to provide a remedy for the lack of long-awaited tax reform, the government has recently created a series of tax incentives for the development of infrastructure projects and for projects that are connected to the 2014 World Cup and the 2016 Olympics. Additionally, the government has on many occasions partnered with private parties in order to develop more complex infrastructure projects (such as, for instance, the Rio de Janeiro-São Paulo high speed train). All this, associated with the discovery of new pre-salt reserves on the coast of Brazil, has made the country a major magnet for external investment.

Clearly, Brazil is the place to be at the moment. If not to explore the ever growing and consuming internal market, then as a bridge to other Latin American countries. The present case study demonstrates that even in a national project, such as a highway, there are several tax incentives and tax benefits from which to choose. The choice for one or another jurisdiction will be an economic one (and will depend on the effective tax burden applied by the other countries). However, at this moment, Brazil would certainly be a heavy contender to receive one such type of investment. The country is definitely open for business.

## II. How to Invest in Brazil: The Choice of Investment Vehicle

### A. Introduction

First and foremost, it is important to mention that foreign or nondomiciled companies are allowed to participate in public bidding proceedings in Brazil, either individually or as part of a consortium.[4] The rules and procedures (*edital*) of the bidding will specify whether the bidding is open to national and foreign companies alike. In case the bidding is open to foreign companies, as well as national companies, the public agent will be precluded from discriminating against either of them.[5] Likewise, the rules of the bidding procedure will determine whether the participation of consortiums will be allowed.[6] In the event that consortiums are allowed, and the consortium involves the participation of foreign entities, leadership in the consortium will always belong to the Brazilian entity.[7] All of members of the consortium will have joint responsibility over the acts undertaken by the consortium during the bidding and execution of the contract.[8]

### B. Branch or Local Subsidiary?

Although it is admissible for foreign entities to participate in Brazilian public bidding procedures, depending on the nature of the project, it might not be recommended to do so. This is so because, if two or more companies (Brazilian or foreign) are regarded to be of equal standing (i.e., in the event of a tie), the criteria to determine the bid winner are based on an analysis of whether the good or service will be produced or rendered in the country by a Brazilian entity.[9] Therefore, depending on the activity subject to the bidding, if there are many competitors apt to provide the same service, it might be more appropriate for a foreign entity to form an SPV or a subsidiary, since, under the rules, the tie-breaker will be Brazilian residence.

From a tax perspective, if the foreign company has to habitually perform business activities in Brazil, it will have to either establish a branch or form a Brazilian subsidiary in order to avoid being irregular when performing its activities in the country. If the foreign legal entity is deemed to be operating irregularly in Brazil, Brazilian tax authorities could be able to tax the profits derived from its activities. Additionally, it should be noted that forming a subsidiary or SPV may be preferable, since setting up a branch involves more bureaucracy and, depending on the individual case, may also involve disputes about taxable revenues and deductible expenses.

The company's actual activity will determine whether it will be better for it to form a subsidiary or simply be admitted into the country as a branch. Brazilian law tends not to stimulate business done through an agency, branch or a permanent establishment: it does this by adding a layer of bureaucracy to the operation of a business through one of these vehicles. By law, foreign legal entities interested in doing business in Brazil through agencies or branches must submit a petition to the Ministry of Commerce, Industry and Development requesting the authorization to operate in Brazil through a highly bureaucratic procedure.[10] Several documents must be presented for the plea to be considered, such as:

(i) a full version of the foreign legal entity's statute or articles of incorporation (or other organizational document);

(ii) a list of its partners or shareholders, containing their names, professions, domiciles, and number of quotas or shares owned;

(iii) a resolution that authorized the operation in Brazil and approved the capital to be invested in the country;

(iv) a resolution appointing the representative of the foreign legal entity in Brazil;

(v) the foreign legal entity´s most recent financial statement; and

(vi) proof of payment of processing fees.[11]

Additionally, any modification made by the company in its articles of incorporation or statute (or other organizational document) should be notified to and approved by the federal government to be effective in Brazil. Any publication of an official notice that was made in the parent company's home country related to financial statements, balance sheets, and administrative acts should also be published in a Brazilian newspaper of wide circulation in the area where the branch or agency is located in Brazil.[12] Failure to do so may lead to cancelation of the license to operate in Brazil. Such cancelation can also be ordered at any other time, regardless of the application of other penalties, in the event of a violation of legislation in the public interest or acts or practices contrary to the public interest.

The main difference between establishing a branch and forming a subsidiary is that, when forming a subsidiary, the company will not need to require the federal government´s approval prior to formation. A subsidiary is also more easily managed, as the rules provide much more flexibility for amending the company's statute or articles of incorporation (or other organizational document). Therefore, foreign entities tend to prefer to do business in Brazil through a subsidiary. Opening a branch can be quite time-consuming, because of all the legal requirements that must be met. The reason why the law favors subsidiaries is so that the foreign entity establishes residency in the country, and Brazil acquires the right to tax the company's revenues on a worldwide basis.

Having said that, it should be noted that Brazilian subsidiaries are taxed on their worldwide income. The two main types of subsidiaries used by foreign inves-

tors to conduct business in the Brazil are (i) Sociedade Anônima (which is a corporation);[13] and (ii) Sociedade de Responsabilidade Limitada (which is a limited liability company).[14]

Brazilian subsidiaries are independent entities for all legal and tax purposes. The liability of the shareholders in a corporation is limited to the issue price of the shares subscribed or acquired by them[15] (in case there is no evidence of fraud, wrongful administration or illegality). The rules of the bid (*edital*) may prescribe a minimum amount of capital as a prerequisite for participating in the bidding procedure. In the case of limited liability companies, the liability of the quota holders is limited to the amount of their respective quotas, but all quota holders are jointly liable for any unpaid portion of the quota capital.[16] Quota holders in limited liability companies will likewise not be held responsible for the company's debt in excess of the capital they have respectively contributed, unless there is evidence of fraud, wrongful administration or any illegality in the administration or liquidation of the company.

### C. As Government Partner

Another way of entering the country and participating in an infrastructure project is as a government partner, through a public-private partnership arrangement. Brazil has a Public-Private Partnership Law (PPP) for projects exceeding twenty million Reais.[17] In this case, an SPV must be formed.[18] All private parties will be subject to a normal bidding process.[19] Under the PPP, the Brazilian Federal Government is allowed to grant incentives pursuant to the Incentive Program for Implementation of Programs of Social interest (PIPS).[20]

### D. Differentiated Hiring Regime

Another point to be made is that Brazil has recently been taking several measures to open up to foreign businesses and facilitate their entry into the country. For that purpose, Brazil has recently created a Differentiated Hiring Regime (*Regime Diferenciado de Contratação*) for the conclusion of projects that are related to the World FIFA Cup of 2014, the Confederations Cup of 2013, and the Olympic and Paralympic games of 2016.[21] Under this regime, the government may either hire private parties through a public bidding procedure, which is simpler and more straightforward when compared to the regular bidding procedure, or determine that there is no need for such a bid and hire a private entity independently (without undergoing a bid) in specific cases.[22]

## III. Form a Business in Brazil or Use an Investment Jurisdiction?

If Highways, Inc. opts to form a direct SPV in Brazil, the main concern revolving the relation between Highways, Inc. and the SPV is that Brazil has so far not entered into a double taxation treaty (DTT) with the United States. Therefore, if the SPV is directly formed by Highways, Inc., there will be no DTT governing this relationship. Normal domestic residence-based tax rules will apply.

However, Brazil does not tax dividend distributions, regardless of who the beneficiary of the dividend is (i.e., regardless of whether the beneficiary is a resident or nonresident, or is in a country with or without a DTT).[23] Therefore, a dividend distribution would not be greatly affected if there were a Brazil—U.S. DTT in force. Generally, remittance of income (e.g. interest) and capital gains to foreign individual or corporate entities domiciled abroad will be subject to withholding for income tax purposes (WHT) at the rate of fifteen percent,[24] regardless of the application of a DTT.[25] Tax on Financial Transactions will also be levied at the general rate of 0.38%[26] upon closing of the exchange rate for remittance of revenues or distribution of profits abroad (this rate may vary depending on the nature of the remittance made abroad, 0.38% being the most commonly applied tax rate).[27] Therefore, if Highways, Inc. does form an SPV, the best option would probably be to contribute capital to it (instead of capitalizing the company using debt).

In case Highways Inc is incorporated in the United States as an LLC, composed of nonresidents of the U.S. and not subject to federal taxes in the U.S., transfer pricing regulations and thin capitalization rules will apply, even if the LLC does not qualify as a related party. That is because in 2010 Brazil classified this type of LLC, among other foreign entities and holding companies, as a "privileged tax regime."[28]

Privileged tax regimes are those that meet one or more of the following requirements: (i) they do not tax income, or tax income at a maximum rate lower than 20%; (ii) they provide tax advantages to nonresidents (individuals or legal entities) conditioned upon the nonperformance of substantial economic activities in the relevant jurisdiction, or without requiring the performance of substantial economic activities in the relevant jurisdiction; (iii) they do not tax income earned outside the relevant territory or tax such income at a maximum rate lower than 20%; and/or (iv) they do not allow access to information about the shareholding (or other ownership) structure of legal entities, ownership of assets and rights or economic transactions performed.[29]

Because the concept of what is deemed to be a "privileged tax regime" is quite broad, in 2010 the government listed what types of entities are to be considered as falling under "privileged tax regimes"[30] (comprising, among others, the LLC regime described above).[31] This list is currently interpreted as an all-inclusive list.[32]

Brazilian domestic income tax rules allow, on a reciprocal basis, a Brazilian subsidiary to offset against Brazilian income taxes the income tax levied on revenues and capital gains paid abroad, limited to the income tax that would have been levied in Brazil on the same revenues

and capital gains if they were taxed in Brazil.[33] Brazil has formally recognized such reciprocity of treatment with respect to U.S. federal income taxes.[34] Therefore, the foreign tax credit is recognized in spite of there not being a DTT with the USA.

For all the reasons cited above (0% tax rate on dividend distributions, right to recognize a foreign tax credit, etc.), U.S. companies generally invest in Brazil directly, without interposing an intermediary company. The advantages of interposing an intermediary company between the United States and Brazil would probably depend on the terms of the DTT between the U.S. and the intermediary country. It is almost impossible to determine whether using an intermediary jurisdiction would be better from a Brazilian tax perspective.

The reason why American companies tend to use direct investment structures with Brazil is multifold:

(i) as previously mentioned, most remittances are subject to a fifteen-percent WHT, regardless of a DTT;

(ii) dividend distributions are not taxed, regardless of DTT provisions;

(iii) Brazil does not provide that the profits clause (DTT clause 7) would be applicable to profits derived from the rendering of services;

(iv) In its DTTs, Brazil generally adopts the ordinary credit method to eliminate the double taxation; however, this is also provided under domestic legislation; and

(v) certain Brazilian DTTs have tax-sparing provisions for passive income (e.g., the Spain-Brazil DTT adopts tax-sparing provisions for the payment of interest; accordingly Spain should grant a credit for the Brazilian income tax levied on interest as if the tax were paid at a twenty-percent rate, despite the application of a fifteen-percent rate as a rule). However, it is not easy, from a practical and economic perspective, to take advantage of tax-sparing clauses, given that normally the source country (e.g., Brazil) taxes gross income, whereas the residence country (e.g., Spain) taxes net income and, therefore, the taxes imposed by the latter may be lower than the taxes imposed by the former, such that it may not be possible to offset, in total or in part, the taxation levied in the source country (i.e., Brazil), against that imposed in the residence country (i.e., Spain).

Despite the foregoing, Spain could probably be used as an intermediary jurisdiction for such an investment. There are a number of reasons that could uphold the use of Spain as an intermediary jurisdiction:

(i) there is a provision in the Brazil-Spain DTT that provides for a reduction in the WHT paid in Brazil to ten percent in certain cases (e.g., in regard to interest paid to financial institutions on loans granted for a ten-year year term for the acquisition of equipment);

(ii) there is a tax-sparing clause in the DTT with Brazil, which may be employed as a practical matter; and

(iii) the large network of DTTs that Spain has with other Latin American countries, and the benefits offered by the Spanish ETVE regime.[35] From the Brazilian perspective, Spanish ETVEs used to be deemed to be privileged tax regimes, but since 2010, they have been temporarily suspended from the list (although they might return after further analysis).[36] It is not advisable to use any tax haven jurisdiction (as included in the Brazilian tax haven list[37]) as an intermediary country for remittances made to tax haven jurisdictions (as included in the Brazilian definition of tax havens), since they are subject to WHT of twenty-five percent. It should be noted that Spain does not fall within the definition of a tax haven.

The conclusive remark is that, since the investment is coming from the United States, the appropriateness of using an intermediary jurisdiction or a holding company should be analyzed from a U.S. perspective, with respect to U.S. DTT partners.

## IV. Capitalizing an SPV in Brazil

### A. Equity

As previously mentioned, if Highways, Inc. opts to form a direct subsidiary (or SPV) in Brazil, it would be best to use equity to capitalize the Brazilian subsidiary. This is so because dividend distributions are not subject to taxation in Brazil.[38] Additionally, gains on the disposal or liquidation of the investment, or gains derived from capital redemptions are generally taxed at fifteen percent, except for the application of a twenty-five percent WHT on payments made to tax-haven jurisdictions.

### B. Debt

On the other hand, from a tax perspective, using debt would probably not be the optimal approach because interest remittances abroad are generally subject to WHT of fifteen percent, regardless of DTT provisions. This tax may be increased if interest is sent to a financial institution, corporate entity or individual located in a tax-haven jurisdiction, in which case it will be subject to WHT of twenty-five percent.

In spite of that, interest paid to Brazilian financial institutions, individuals or corporate entities in Brazil is generally tax deductible for the Brazilian SPV (provided that it is necessary and usual to the corporate business) but could be subject to tax by the interest recipient.[39]

It should be noted that Brazil has recently developed thin-capitalization rules (which are enforceable but are still largely unregulated) to determine the deductibility of interest in loan transactions between (i) related parties;[40] (ii) parties located in tax havens; (iii) parties located in privileged tax regimes; and (iv) certain transactions carried out with the intervention of covered parties or certain back-to-back transactions.[41] The general debt/equity ratio is 2:1 in Brazil. However, the table posted in item (v) below may best illustrate the indebtedness limits among the aforementioned parties:

| | **Creditor** | | |
|---|---|---|---|
| **Limit** | **Related Party *not* domiciled in a tax haven and not subject to a preferred tax regime, *with* equity stake in the Brazilian legal entity** | **Related party *not* domiciled in a tax haven and not subject to a preferred tax regime, *without* equity stake in the Brazilian legal entity** | **Related or unrelated party domiciled in a *tax haven or subject to a preferred tax regime*** |
| **Individual** | Debt must not exceed twice the value of the creditor's equity stake in the Brazilian legal entity's net worth | Debt must not exceed twice the Brazilian legal entity's net worth | Debt must not exceed thirty percent of the Brazilian legal entity's net worth |
| **Collective (debts with related parties with equity stakes in the Brazilian legal entity or debts with related parties with and without equity stakes in the Brazilian legal entity)** | Debt must not exceed twice the value of the creditors' equity stakes in the Brazilian legal entity's net worth | | |
| **Collective (exclusively for debt with related parties without equity stakes in the Brazilian legal entity)** | Not applicable | Debt cannot exceed twice the Brazilian legal entity's net worth | |

If interest is paid to a foreign related entity, its deductibility may also be subject to the application of transfer-pricing rules.[42] It should be noted however, that the application of transfer-pricing rules is only an issue if the loan is not registered with the Brazilian Central Bank (the "Bacen"). Since loans granted by foreign individuals or financial and non-financial institutions to Brazilian legal entities shall be registered with the Bacen, transfer-pricing provisions do not tend to pose a problem when remitting back the interest levied on those loans. Transfer pricing tends therefore to reach loans granted by Brazilian parties to foreign counterparties (because these loans cannot be registered with the Bacen). It should be noted that this would not be the case under the proposed structure. Brazilian rules are not clear on how transfer-pricing rules and thin-capitalization provisions are to interact.

It is also important to mention that Brazilian tax law presumes the nondeductibility of costs and expenses derived from foreign entities residing in tax-haven jurisdictions (the U.S. is not characterized as such a jurisdiction) or derived from transactions carried out under privileged tax regimes, unless certain requirements are met (e.g., where the taxpayer proves the need for the cost, expense, good, service or right acquired, and the operational capacity of the non-resident to enter into the transaction).

## V. Tax Treatment of the Infrastructure Project in Brazil in Each of the Phases of Operation (i.e., Construction, Operation, and Maintenance)

### A. In General

Brazil has two main regimes for calculating corporate taxes (a twenty-five-percent corporation income tax or IRPJ and a nine-percent social contribution on net profits or CSLL), as follows:

(i) the deemed-profit regime (which involves taxation based on presumed profit margins over gross revenues from sales of goods and services); and

(ii) the actual-profit regime (which involves taxation based on accounting profits, calculated in accordance with the Brazilian accounting rules in force as of 31 December 2007, adjusted for tax purposes).

However, Brazilian civil construction companies whose total revenues in the previous tax base period exceed BRL forty-eight million or that benefit from recognizing revenues based on budgeted costs of the construction work are obligated to calculate corporate taxes based on the actual-profit regime. Thus, they are precluded from opting for the deemed-profit regime.

Under the actual-profit system, tax losses can be carried forward, and no statute of limitations applies for this purpose (carry-backs are not allowed). However, tax losses cannot reduce the taxable profits by more than thirty percent. This provision might be important, depending on the facts of the case at the time.

The Brazilian SPV would be characterized as a wholly Brazilian entity and, as such, subject to all other taxes levied on a Brazilian entity; these are mainly as follows:

(i) Import Tax (IT)—IT is levied at variable rates according to the tax classification of imported goods;

(ii) Excise Tax (IPI)—IPI is levied on imports and the sale of goods imported or manufactured by the taxpayer, at variable rates depending on the tax classification and nature of the goods (e.g., goods of primary need are taxed at lower rates, whereas other goods are taxed at higher rates);

(iii) State Tax on the Circulation of Goods and Services (ICMS)—ICMS is levied on imports of goods and certain services, and on the circulation of goods and certain services within the national territory, at variable rates per state and type of the taxable good or service. Normally, an eighteen percent tax rate applies to imports of goods, intrastate transactions, and interstate transactions with goods shipped to non-ICMS taxpayers. Interstate transactions with goods shipped to ICMS taxpayers are subject to a seven or twelve percent rate. The seven percent tax rate applies to shipments of goods from the south and southeast regions of Brazil to the north, northeast or middle west regions of Brazil, or to the State of Espírito Santo, and the twelve percent rate applies to all other cases (the state law allocates to the recipient of the good the responsibility to pay the difference between the interstate and the intrastate tax rate);

(iv) Municipal Service Tax (ISS)—ISS is generally levied on imports of services, and on the provision of services within the domestic market at rates varying per municipality and type of service, generally ranging from two to five percent; and

(v) Social Integration Program Contribution (PIS) and Contribution to Finance Social Security (COFINS)—PIS and COFINS are levied on imports of goods and services (generally at the combined rate of 9.25%) and on the turnover of Brazilian legal entities (generally at the combined rates of 3.65% under the cumulative regime, or 9.25% under the non-cumulative regime).

IPI and ICMS are non-cumulative taxes, that is, the taxpayer may book credits for the taxes paid on imports, or passed on by being included in the price of goods purchased in the domestic market, to offset debts of the same taxes resulting from other taxable transactions.

PIS and COFINS levied on sales (gross income) of Brazilian legal entities may be cumulative or noncumulative taxes, generally depending on the method used by the legal entity to calculate its business taxes. If the actual-profit method applies, certain tax credits can be used to offset PIS and COFINS debts, and if the deemed-profit method applies, the taxpayer is not entitled to PIS and COFINS credits. However, civil construction companies are subject to the cumulative regime, thereby allowing them to, until 2015, tax under the lower combined rate of 3.65%. Unfortunately, this also means that civil construction companies are not entitled to compute credits, pursuant to specific legal provisions of their special regime.

The other taxes are levied in cascade fashion.

The regime and taxes described above are those which would be levied under normal conditions, were the company (or SPV) not to be entitled to any special tax regime or tax benefit. However, as mentioned in the introduction, Brazil has recently been creating a series of tax incentives to draw foreign investment attention towards the country, especially in the area of infrastructure development (transport is considered to be one of the priority areas by the current government). This means that an SPV recently formed in Brazil wishing to explore a public highway concession would probably not be subject to all of the taxes described above at their full tax rate.

### B. Special Tax Incentive Regimes for Infrastructure Development (REIDI)

The following is a brief description of the main special regimes and tax incentives currently available under

the Brazilian legislation for the development of an infrastructure project.

REIDI benefits apply, among others, to corporate entities wishing to implement infrastructure projects in the transport sector. However, Highways Inc, through its Brazilian SPV, would still have to observe some eligibility requirements provided by law.[43]

In general terms, REIDI suspends the incidence of PIS/COFINS on the acquisition, the leasing and sale of new equipment and construction materials from the internal market or from abroad, as long as these products and materials are incorporated into the infrastructure project. PIS and COFINS are also suspended on the acquisition of local services or imported services, when those services are destined to be incorporated into the infrastructure project.[44]

### C. Financial Investments in Infrastructure Projects

#### 1. Overview

The government of Brazil encourages financial investments in infrastructure projects. This happens, for example, with investments in infrastructure funds, such as the so-called FIP-IEs (*Fundos de Investimento em Participacoes em Infra-Estrutura*), and investments in debentures issued by SPVs that develop infrastructure projects.

#### 2. Investments in an FIP-IE

The objective of this fund is to invest in national infrastructure projects, such as the transport sector.[45]

Income paid by an FIP-IE to a Brazilian tax resident (individual or legal entity) is subject to a fifteen percent WHT (which is a final tax for individuals) upon redemption of the shares from the fund or liquidation of the fund.[46]

Capital gains verified upon the sale of the fund's shares are subject to zero percent WHT if earned by individuals residing in Brazil, and are exempt from taxation on the annual individual income tax. The same capital gain is subject to a fifteen percent WHT if earned by a Brazilian legal entity.[47]

It should be mentioned that there are arguments to support treating income (and capital gains) earned by non-residents from their investments in an FIP-IE as being subject to zero percent WHT. [48] However, the most conservative approach would result in a WHT rate of fifteen percent on income and capital gains earned by nonresidents.

#### 3. Investments in Debentures to Finance Infrastructure Projects

The government also allows SPVs (that are nonfinancial institutions) to issue debentures connected to infrastructure projects, whose revenues are taxed with (i) zero percent WHT if paid to non-residents or individuals who are Brazilian tax residents;[49] or (ii) a fifteen percent WHT if paid to Brazilian legal entities.[50]

The same taxation applies to investment funds that invest in the debentures described above, as long as such investment represents at least eighty-five percent of the fund´s net worth.[51]

### D. Other Tax Benefits and Incentives

Brazilian legislation also provides fixed, regional incentives for projects of interest, aimed at the development of the north and northeast regions. Therefore, if the highway cuts through any of those two regions (e.g., Colombia has borders with the northern part of Brazil, which would be relevant if the highway is an international highway), it will most likely be eligible to request benefits under one of these programs.

Municipal and state incentives may be granted on a case-by-case basis, based on the project´s estimated generation of jobs, need for construction of the highway, profit forecast, annual turnover, and the like.

Since the beginning of the Lula Administration in 2000, the government has been focusing on the dissemination of social programs, which are intended to provide faster growth and infrastructure development, while providing optimal conditions for upward social mobility by the lower classes (by giving them jobs, education, security, basic sanitation, and the like). Two major government programs have been launched since then: the Growth Acceleration Program (PAC), initiated under the Lula administration and carried through by the current Dilma administration; and (ii) the Bigger Brazil Program (Programa Brasil Maior), which has recently been launched by President Dilma. These two programs were designed to advance the government´s aim to develop new infrastructure. The agenda for these two programs may lead to the creation of additional benefits in the near future, especially under the context of the 2014 World Cup and the 2016 Olympic games in Rio de Janeiro.

## VI. Importing the Equipment Needed to Construct the Highway in Brazil

When one thinks about importing the equipment used for construction and operation of the highway in Brazil, the question always arises as to whether the better option would be to lease the equipment or just import it permanently into the country. Leasing the equipment could be the most interesting option if the SPV were able to adhere to a special customs regime to import the machinery and equipment needed for the highway construction and maintenance. The determination of whether it will be better to import or lease the equipment or machinery will depend on the term of duration of the lease.

One such special customs regime is called the temporary admissions regime.[52] The temporary admissions regime may be granted upon the proportional payment of taxes levied on imports (in this case, the taxes would be levied proportionately to the time the equipment is supposed to remain in the country).[53] The importer may have to provide the government with a guarantee (corresponding to the amount of suspended taxes) and will have to sign an agreement of responsibility. The imported product has got to be re-exported by the end of the fixed term of permanence of the product in the country. Penalties apply if the beneficiary of the regime is unable to re-export the product or import it (by paying the suspended taxes) to the internal market.[54]

By contrast, the following taxes would be levied if the goods were to be imported directly into Brazil (without the use of a special customs regime): II, IPI, ICMS and PIS and COFINS, as explained above.

Therefore, the facts of the case and the circumstances of the product will in fact determine whether it would be better for the SPV to lease or to import the good or acquire it in the internal market. Importing a product would only be beneficial if the SPV is eligible for one of the admissible special customs regimes. In light of import and transport costs (to and from the country), it might be less expensive to effectively acquire some of the goods (consumables, for example) from the internal market.

Please note that under no hypothesis should the SPV consider the possibility of importing used equipment or material. Although there is legislation admitting the importation of (some) used products and materials,[55] the process is absolutely enmeshed in bureaucracy. The imported product has to undergo the scrutiny of local producers (who may refute applicability of the legislation through a public consultation phase), and this is very time-consuming. For this reason, it is not advisable to import used equipment, machinery or products into Brazil.[56]

## VII. Importing Services into Brazil

If Highways, Inc. provides cross-border services to the local SPV, the following taxes will be levied upon remittance of revenues from SPV to Highways, Inc. in payment of the services:

(i) WHT at the rate of fifteen percent;[57]

(ii) PIS/COFINS-Import at the combined rate of 9.25%,[58]

(iii) Contribution for Intervention on Economic Domain (CIDE), at the rate of ten percent; and

(iv) ISS, at a maximum rate of five percent, depending on the municipality in which the recipient (i.e., the SPV) is located.[59]

Therefore, the main issue in the fact pattern at hand is the heavy tax burden imposed on imports of services by a Brazilian legal entity, which may reach approximately fifty percent if there is a gross-up provision. Additionally, issues related to the irregular presence of the foreign legal entity in Brazil could arise in specific circumstances.

If local workers are hired to help render the cross-border services, local labor and social security laws on employment may apply with respect to the SPV.

## VIII. Conclusion

Two main conclusions may be derived from the foregoing discussion. The first one is that Brazil has a really complex and burdensome tax system. The second is that, despite the tax burden, the Brazilian government has been going out of its way to make conditions favorable for foreign direct investments. It is impossible to determine whether Brazil would be the best jurisdiction among those under consideration to receive the highway project. However, as far as tax benefits go, it would probably be one of the better options.

## Endnotes

1. In August 2010, the Federal Revenues Service published data referring to the overall tax burden levied on Brazilian taxpayers in 2009. The study takes into account the fact that 2009 was an unusual year, due to the world economic crisis.
2. Brazil's overall gross tax rate is higher than very well developed countries such as Japan (17.6%), United States (26.9%), Switzerland (29.4%) and Spain (33%).
3. For more information on the research, http://www.receita.fazenda.gov.br/Historico/esttributarios/estatisticas/CargaTributariaBR2009.htm.
4. Law 8666/93, art. 3.
5. *Id.* art. 3, items I and II.
6. *Id.* art. 33.
7. *Id.* art. 33, § 1.
8. *Id.* art. 33, item V.
9. *Id.* art. 3, § 2, items I through IV.
10. IN DNRC [Normative Instruction of the National Department of the Commercial Registry] 81/99, art. 1.
11. *Id.* art. 2, items I through VIII.
12. *Id.* arts 6 and 7.
13. Brazilian Civ. Code, Law 10406/2002, art. 1088.
14. *Id.* arts. 1052 to 1054.
15. Law 6404/76, art. 1.
16. *Id.* 10406/2002, arts. 1052, 1055.
17. Law 11079/04, art.2, § 4, item I.
18. *Id.* art. 9.
19. *Id.* art. 10.
20. *Id.* art. 23.
21. Law 12462/11, art. 1.
22. *Id.* art. 35.
23. Law 9.249/95, art. 10.

24. Income Tax Reg. art. 682.
25. *Id.* art. 685.
26. Tax on Financial Transactions Regulation, Decree 6306/07, arts. 15 and 15-A.
27. *Id.* art. 15-A.
28. Normative Instruction 1037/10, art. 2.
29. Law 9430/96, art. 24-A.
30. The following cases qualify as privileged tax regimes: the regime applicable to the Sociedad Anonima Financiera de Inversion (SAFI) set out in the legislation of Uruguay until 31 December 2010; the regime applicable to holding companies set out in the legislation of Denmark, if they do not carry substantial activity; the regime applicable to the International Trading Company (ITC) set out in the legislation of Iceland; the regime applicable to the Offshore KFT set out in the legislation of Hungary; the regime applicable in the United States to limited liability companies (LLCs) formed of nonresidents and not subject to federal income tax, set out in the legislation of the United States of America; and the regime applicable to the International Trading Company (ITC) and the International Holding Company (IHC) set out in the legislation of Malta. IN 1037 used also to include the regime applicable to holding companies set out in the legislation of the Netherlands, if they do not carry out any substantial activity, and the regime applicable to the Entidad de Tenencia de Valores Extranjeros (ETVE) set out in the legislation of Spain, in the list. However, following the edition of IN 1045 the inclusion of Netherlands and Spain was questioned by the Dutch and Spanish governments, and thereupon temporarily suspended from the list. According to Executive Declaratory Act 10 of 24 June 2010, and Executive Declaratory Act 22 of 30 November 2010, the effects of the inclusion of the Netherlands and Spain was suspended until further analysis. For the time being, therefore, the Netherlands and Spain are not considered to be privileged tax regimes.
31. Normative Instruction 1037/10, art. 2, item VII.
32. If Highways, Inc. is an LLC and is characterized as a privileged tax regime, the legislation will presume the costs and expenses incurred by the LLC to be nondeductible. In order to counter that presumption, the LLC will have to prove that the business entity (i.e., the LLC) has operational capacity.
33. Income Tax Reg. art. 395.
34. Declaratory Act 28/00.
35. It should be noted that the greatest benefits derived from the use of ETVEs would come from investments in other countries.
36. Declaratory Executive Act 22/10.
37. According to IN SRF 11037/10, the following may be characterized as tax havens (i.e., deemed to be low-tax jurisdictions): Andorra; Anguilla; Antigua and Barbuda; Netherlands Antilles; Aruba; Ascension Island; Bahamas; Bahrain; Barbados; Belize; Bermuda Island; Brunei; Campione D'Italia; Channel Islands (Alderney, Guernsey, Jersey and Sark); Cayman Islands; Cyprus; Singapore; Cook Islands, Costa Rica; Djibouti; Dominica; United Arab Emirates; Gibraltar; Granada; Hong Kong; Kiribati; Labuan; Lebanon; Liberia; Liechtenstein; Macao; Madeira Island; Maldives; Man Island; Marshall Islands; Mauritius; Monaco; Montserrat Islands; Nauru; Niue Island; Norfolk Island; Panama; Pitcairn Island; French Polynesia; Qeshm Island; American Samoa; West Samoa; San Marino; Saint Helen Islands; Saint Lucia; Saint Kitts and Nevis Federation; Saint Peter and Saint Miguel Islands; Saint Vincent and Grenadines; Seychelles; Solomon Islands; Swaziland; Sultanate of Oman; Tonga; Tristan da Cunha Islands; Turks and Caicos; Vanuatu; British Virgin Islands; and U.S. Virgin Islands. It should be noted that Switzerland used to also be on the list of tax havens, but was excluded due to the Swiss government´s request. Pursuant to Executive Declaratory Act 11 of 24 June 2010, Switzerland was removed from the list for further analysis by the Brazilian government. Switzerland is therefore currently excluded, until further analysis of its request.
38. Law 9.249/95, art. 10.
39. Income Tax Reg. art. 374, item II.
40. If the loan taken with the related party is not registered with the Central Bank, then pursuant to Article 22 of Law 9430, interest expenses shall not exceed the LIBOR for six-month deposits in U.S. Dollars, plus a three percent spread, calculated in proportion to the interest payment term.
41. Law 12249/10, as regulated by Normative Instruction 1154/11.
42. Law 9430/96, arts. 18 to 21, as regulated by IN 243/02.
43. Law 11488/07, as regulated by Normative Instruction 758/07.
44. Normative Instruction 758/07, art. 2, Items I and II.
45. Law 11478/07, art. 1.
46. *Id.* art. 2.
47. *Id.* art. 2, §3.
48. Law 11312/06, art. 3.
49. Law 12431/11, art. 1.
50. *Id.* art. 2.
51. *Id.* arts. 3, §§ 6 and 9.
52. Customs Reg., Decree 6759/09, art. 353.
53. *Id.* art. 373.
54. Normative Instruction 285/03 provides the rules of the regime. Conditions and eligibility requirements apply.
55. DECEX Ordinance 8/91, arts. 22 to 25 provide what kinds of goods and materials may be imported into the country. All other products/materials are disallowed.
56. On this issue, see DECEX Ordinance 8/91, as amended by Ordinance MDIC 235/06.
57. Income Tax Reg. art. 685, item I.
58. Law 10865/04, art. 1, § 1, item I; and art. 8, items I and II.
59. Supplementary Law 116/03, art. 1, § 1.

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# Utilizing Tax Incentives for Infrastructure Ventures in Latin America: The Colombian Perspective

By Lucas Moreno Salazar

## I. Introduction

This article analyzes some of the main tax considerations that a foreign investor should bear in mind when investing in Colombia. These main considerations are covered in the Highways, Inc. case study set out above.

## II. The Choice of Investment Vehicle: a Domestic SPV or a Branch?

Highways, Inc. should form a local entity in Colombia. In fact, foreign non-domiciled entities are allowed to participate directly in a bidding process and to enter into contracts with public entities under the same conditions as Colombian bidders. However, if a foreign non-domiciled entity, after the bidding process, is selected to enter into a public contract with the Colombian government or a public entity, it will be deemed to undertake "permanent activities"[1] in Colombia. Under Colombian tax law, foreign nondomiciled entities must undertake "permanent activities" through a Colombian vehicle and, therefore, Highways, Inc. may form any of the following legal entities to execute the public contract: (i) it could establish a Colombian branch, or (ii) it could incorporate a Colombian subsidiary. The Colombian corporate income tax rate is of 33%[2] and it applies irrespective of whether the Colombian entity is a branch or a subsidiary.[3]

A Colombian branch is taxed exclusively on its Colombian source income.[4] Additionally, it is deemed to be an extension of its foreign home office and, therefore, the foreign entity has unlimited liability for the tax obligations of the Colombian branch. The foreign entity (i.e., the home office) does not have to file a separate income tax return. Its Colombian branch will have to file a tax return, with its income tax based (exclusively) on its Colombian source income.

Colombian subsidiaries are taxed on their worldwide source income. The three main types of subsidiaries used by foreign investors are (i) *Sociedades Anónimas* (the equivalent of corporations), (ii) *Sociedades de Responsabilidad Limitada* (the equivalent of limited liability companies), and (iii) *Sociedades por Acciones Simplificadas*[5] (also the equivalent of corporations). For all legal and tax purposes, Colombian subsidiaries are legal entities that are independent from their shareholders, members or partners.[6] Consequently, shareholders of *Sociedades Anónimas and Sociedades por Acciones Simplificadas* are, in principle, liable for the subsidiary's tax obligations to the extent of the amounts they have contributed to the subsidiary. However, in the case of *Sociedades de Responsabilidad Limitada* members or partners are liable for the company's tax obligations in proportion to their participation in the subsidiary's capital.

It is advisable for Highways, Inc. to incorporate a *Sociedad por Acciones Simplificada (simplified stock company*) because this legal entity does not require a public deed of incorporation public deed (unless real estate assets are being contributed); it can be incorporated with a single shareholder; and its capital may be divided into different kinds of shares, which can be, in general, freely negotiated by a simple endorsement, unless the company's bylaws provide for rights of first refusal in favor of the remaining shareholders.[7]

A foreign non-resident entity that is party to a public contract through a joint venture agreement (or a similar association agreement) with a local entity is required to incorporate a Colombian entity since it would otherwise be deemed to undertake permanent activities in the country.[8]

## III. Form an SPV in Colombia or Use an Investment Jurisdiction?

It is advisable for Highways, Inc. to hold its participation in the Colombian entity through one of its subsidiaries located in a jurisdiction that is party to a double-taxation treaty (DTT) and/or a bilateral investment treaty (BIT) with Colombia.[9]

In general terms, BITs provide general investment protection mechanisms, including fair and equal treatment, most-favored-nation clauses, and protection against direct and indirect expropriation not fairly compensated for by the Colombian government.

BITs also provide for arbitration with the International Center for Settlement of Investment Disputes Convention (ICSID) under the ICSID's Rules of Procedure for Arbitration Proceedings or under the arbitration rules of the United Nations Commission on International Trade Law.

The following is a list of the DTT and BIT agreements that Colombia has entered into or is in the process of negotiating or entering into.

| Jurisdiction | DTT with Colombia | BIT with Colombia |
|---|---|---|
| Spain | Enforceable | Enforceable |
| Chile | Enforceable | Signed. Pending: exchange of instruments of ratification |
| Andean Community (Peru, Ecuador and Bolivia) | Enforceable | Enforceable |
| Switzerland | Enforceable | Enforceable |
| Canada | Signed | Enforceable |
| South Korea | Signed | Signed |
| Mexico | Signed | Enforceable |
| India | Signed | Signed |
| France | Negotiated | N.A. |
| Belgium | Negotiated | Negotiated |
| Czech Republic | Negotiated | N.A. |
| United States | Being negotiated | Signed |
| Japan | Being negotiated | Being negotiated |
| Germany | Being negotiated | N.A. |
| The Netherlands | Being negotiated | N.A. |

There are two main issues that should be considered by Highways, Inc. if the Colombian entity's holding company is located in a jurisdiction that has no DTT with Colombia. Firstly, capital gains derived from a further sale of the Colombian entity will be subject to income tax in Colombia at a thirty-three percent rate.[10] Secondly, the Colombian general rules on taxation of dividends will apply. In this regard, the Colombian tax law provides for an imputation tax system, according to which income tax is only levied on dividends paid out of profits that were not taxed at the corporate level. Therefore, dividends paid out of profits that were not taxed at the level of the subsidiary will be subject to income tax at a thirty-three percent rate upon distribution as dividends (normally collected through income tax withholdings at the same thirty-three percent rate if the investor is not domiciled in Colombia).[11]

If the Colombian entity's holding company is located in a jurisdiction with an enforceable DTT with Colombia, different rules regarding taxation of capital gains and dividends may apply. Consequently, it is advisable to analyze the possibility of investing in Colombia through Spain, since that country has a convenient tax system for holding companies (e.g. a participation exemption regime and a tax regime for the so-called *Empresas Tenedoras de Valores Extranjeros* or ETVE). Pursuant to the Spain-Colombia DTT, income derived from the sale of shares in Colombian companies is only subject to taxes in Spain. However, such income may also be taxed in Colombia if fifty percent or more of the value of the shares is comprised of real estate located in Colombia.[12] It is worth analyzing whether the concession rights to be eventually granted to the Colombian entity are considered real property in order to determine whether capital gains derived from the sale of the local entity will be taxed in Colombia or not.

As far as dividends are concerned, the Spain-Colombia DTT sets forth zero percent income tax withholding on dividends paid to shareholders domiciled in Spain holding at least twenty percent of the shares of a Colombian company. As of December 2011, dividends are subject to a special dividend tax in Colombia at a zero percent rate and, therefore, the DTT would, in principle, not provide any benefit. However, it is important to take into account that the special dividend tax rate in Colombia could be increased by the Colombian government at any time and, therefore, the zero percent income tax withholding under the DTT could become beneficial.

If Highways, Inc. decides not to hold its participation in the Colombian entity through a company located in a DTT jurisdiction, it should study the possibility of using a subsidiary located in a tax haven jurisdiction as a holding company. In principle, there are no significant differences between having a holding company in a non-treaty jurisdiction or in a tax haven jurisdiction since the tax treatment applicable to (i) capital gains derived from the sale of the Colombian subsidiary or (ii) payments of dividends does not change if the shareholder is located in a tax haven jurisdiction. However, it is important to mention that Colombian tax law does provide for rules limiting the deduction of certain payments (not usually made to holding companies—e.g., royalty payments or payments as consideration for services) if the payment's recipient is located in a tax haven jurisdiction.[13] For example, only payments that have been subject to income tax withholdings are deductible for tax purposes.

## IV. Tax Treatment of Funding

The Colombian entity may be funded with equity or debt. If funded with debt, it is worth noting that Colombia does not have thin-capitalization rules; however, the Colombian government is planning to propose a tax bill in 2012 that may include thin-capitalization rules.[14] Consequently, Colombian legal entities could be funded with debt to the extent desired. The Colombian Central Bank has recently changed the foreign exchange regime, allowing foreign nonfinancial entities to grant loans to Colombian entities.[15]

Interest payments to foreign nonresidents from loans granted to Colombian entities are deemed Colombian source income and subject to income tax (collected by way of income tax withholding). In the case of short-term loans (i.e., loans for less than one year) the applicable income tax withholding rate is thirty-three percent, while long-term loans are subject to a fourteen percent rate.[16] In both cases, the withheld amounts would become the

foreign lender's tax liability in Colombia (i.e., no obligation to file an income tax return in Colombia arises), provided that (i) all the foreign lender's Colombian source income is subject to income tax withholding and (ii) such withholding is effectively applied.[17] A foreign tax credit may be available to the foreign lender in its residence jurisdiction.

If the loan is granted by an entity domiciled in Spain, interest payments may be subject to a reduced income tax withholding since such payments will be subject to the tax treatment set forth under the DTT with Spain. In general terms, interest payments to a resident of Spain may be taxed in Spain. However, such interest could also be taxed in Colombia. If the beneficial owner of the interest payments is a resident of Spain, the tax so charged shall not exceed ten percent or zero percent of the gross amount of the interest (i.e., ten percent withholding tax with a nonfinancial institution or zero percent withholding tax with a financial institution or supplier or governmental entity). Consequently, under the DTT the tax withholding rate on interest applicable in Colombia could decrease from thirty-three or fourteen percent to ten or zero percent (applicable to financial institutions).

Interest payments between related entities are subject to the Colombian transfer pricing regime. According to this regime, income taxpayers who carry out transactions with related parties domiciled outside Colombia are required to determine their ordinary and extraordinary income, cost and deductions, considering prices and profit margins that would have been used with or between independent parties (i.e., on an arm's-length basis).[18]

Under the transfer pricing regime there are several circumstances or scenarios under which two entities (or individuals) are deemed to be related parties:[19]

- A parent company and its subordinate.
- Two subordinates of the same parent company.
- Two entities whose shares are directly or indirectly owned, to the extent of fifty percent or more, by the same shareholder.
- Two companies, one of which owns, directly or indirectly, fifty percent or more of the capital of the other.
- Two companies, whose capital belongs, to the extent of fifty percent or more, to individuals related to each other by marriage or parenthood, including the second level of consanguinity or affinity; or by civil law.
- A company and one of its partners or shareholders that owns fifty percent or more of the capital of the company.
- A company and one of its partners or shareholders who is entitled to manage the company.
- Two companies whose capital belongs, to the extent of fifty percent or more, to the same persons or to their spouses or relatives within the second level of consanguinity, affinity; or by civil law.
- A producer selling to one same company or to companies that are related reciprocally, through the purchase and sale of fifty percent or more of the producer's production, in which case each of the companies will be taken as an economically related company.

Based on the above, the Colombian entity and the foreign related lender must set up the interest yield on an arm's-length basis (i.e., at fair market value).

The Colombian entity should file an annual informative transfer pricing return listing the operations carried out with its related parties, and it should also prepare supporting documentation, if the following requirements are met:

- It has gross equity on the last day of the taxable year or period equal to or in excess of the equivalent in Colombian pesos to one hundred thousand Tax Assessment Units (approximately USD $1,322,737 for 2011); and
- Its gross income for the fiscal year exceeds the equivalent in Colombian pesos to sixty-one thousand Tax Assessment Units (approximately USD $806,869 for 2011).

The Colombian entity will have to prepare transfer pricing supporting documentation if the transaction with the foreign related party exceeds the equivalent in Colombian pesos to ten thousand Tax Assessment Units (approximately USD $132,273 for 2011).

Finally, interest payments to the Colombian entity's foreign related entity would be tax deductible if general requirements on tax deductions are met; (i) the expense (i.e., interest payments) is related to the taxpayer's income-generating activity; (ii) it is needed to undertake the income-generating activity (this condition would be evaluated under commercial criteria); and (iii) it is proportional to the taxpayer's taxable income (in the relevant fiscal year).

Additionally, in the case of interest payments to a foreign parent, such payments are tax deductible if they are subject to the transfer pricing regime and the corresponding income tax withholding is applied.

The Colombian Tax Code provides that interest payments are only deductible up to an amount not exceeding the highest interest rate that the Colombian financial entities are authorized by the government to charge during the corresponding taxable year.

If funded with equity, the Highways, Inc. group should bear in mind that contributions to the Colombian

entity can be made to either the entity's capital account or its share premium account. Capital contributions to the entity's capital account are subject to registration tax, notary fees and value-added tax (VAT) on the notary fees at an aggregate tax burden of 1.048% applicable to the contributed amounts. However, as mentioned above, in the case of simplified stock companies, no public deed is required and, therefore, notary fees and VAT do not accrue (i.e., the aggregate burden is 0.7%).[20]

On the other hand, contributions to the share premium account are not subject to registration tax, notary fees or VAT on the notary fees. Consequently, the amount contributed as share premium is not subject to the 0.7% or 1.048% aggregate tax burden. Additionally, pursuant to current tax rules share premiums do not constitute taxable income for the Colombian entity, as long as such amounts are accounted for as capital surplus that is not eligible for distribution to the company's shareholders.[21] Consequently, future repatriation of such amounts via capitalization of the share premium account followed by a capital reduction may trigger income tax at a 33% rate applicable on the repatriated amount. With this in mind, note that contributions as share premium would represent a tax saving in the short term (0.7% or 1.048%), but would lead to a tax inefficiency when repatriating such funds in the future (i.e., 33% income tax).

## V. Tax Treatment of the Project in Each of the Phases of Operation (i.e., Construction, Operation, and Maintenance)

### A. In General

The Colombian entity will be subject to the following principal Colombian taxes: (i) income tax, (ii) VAT, (iii) a local industry and commerce tax, and (iv) a debit tax.

Corporate income taxes currently are payable at a rate of thirty-three percent of the taxpayer's taxable income. In addition to general deductions,[22] taxpayers are allowed to deduct loss carryovers readjusted for inflation indefinitely or without limitation. There is an alternate income tax computation, whereby an alternative minimum taxable income is computed at three percent of the Colombian entity's equity in the previous year (whereby it is noteworthy that tax rules must be taken into account in determining the Colombian subsidiary's equity).[23]

Local sales and imports of personal property are subject to VAT in Colombia at the general rate of sixteen percent.[24] Formally, the VAT is ultimately borne by the final consumer under an input VAT credit mechanism.

The industry and commerce tax (which, as noted above, is local) is levied on the taxpayer's gross revenue earned from any industrial, commercial or service activities undertaken in each municipality, at rates that range from 0.2% to three percent depending on the location and type of activity.

Finally, the debit tax is a national tax levied on financial transactions at 0.4% on the gross amount of the transaction.[25]

In addition to these taxes that are generally applicable to a Colombian entity, parties to governmental or public agreements under which highways or other types of immovable construction are built are subject to a special duty levied at a 0.25% on the gross amounts being collected under the concession.[26]

### B. Tax Incentives

Colombian tax law does not provide significant tax incentives applicable to investors participating in infrastructure projects. One of the few incentives is related to the possibility of treating financial lease agreements as operating leases, which means that the financial yield component is not differentiated from the capital component, and, therefore, the total payment amount can be deducted by the lessee.[27] However, this special treatment may apply only to lease agreements entered into before 10 January 2012.[28]

Investors may apply for legal stability agreements to be entered into with the Colombian government, whereby the state guarantees the stability of certain rules deemed vital to a given investment project. Consequently, during the term of the legal stability agreements, investors are entitled to apply the rules defined as crucial to their investments, even in the case in which those rules are modified (in a way that adversely affects the investor). On the other hand, investors are obliged to (i) make new investments for an amount higher than USD $1,411,824;[29] and (ii) pay the corresponding legal stability premium determined by the Government in accordance with the tax rules that are stabilized.[30]

## VI. Acquiring the Equipment

The Highways, Inc. group should decide whether it is going to sell or lease the equipment to the Colombian entity or whether it will procure the funds for the Colombian entity so that it can locally acquire the equipment needed to build the highway. If the Highways, Inc. group decides to sell the equipment to the Colombian entity, the purchase agreement should be clear as to where the equipment will be located when legal title passes to the buyer (i.e., Colombian entity). If the equipment is located outside Colombia, any gain on the sale would not be deemed Colombian source income and, therefore, the seller would not be subject to income tax in Colombia.[31] The importation of the equipment will be subject to VAT at a rate that may vary depending on the nature of the equipment.

If the equipment is leased to the Colombian entity, it is important to determine whether such lease qualifies as a financial lease.[32] If that is the case, the lease payments will be subject to fourteen percent income tax withhold-

ing on the financial yield component.[33] This means that no income tax withholding should be applied on capital payments. Additionally, under a financial lease agreement, the financial yield component, as well as the depreciation allowance, is fully deductible. Moreover, international leasing agreements do not trigger VAT.[34]

If the lease does not qualify as a financial lease, any lease payments will be subject to income tax withholding at the rate of thirty-three percent. The lease payment should be tax deductible as long as the income tax withholdings are applied.[35]

If the Highways, Inc. group decides to procure the funds for the Colombian entity so it can acquire the equipment in the local market, the discussion above in connection with the mechanisms to fund the Colombian entity (i.e., equity or debt) should be considered.

There are certain foreign-trade tools that may offer important savings in connection with customs duties (i.e., tariffs and VAT) on goods and equipment to be imported by the Colombian entity, and, therefore, should be reviewed on a case-by-case basis. These include the following: (i) temporary imports (short and long term), and (ii) imports under free trade agreements.

The discussion above regarding the Colombian transfer pricing regime should be considered in connection with the foregoing.

## VII. Rendering Cross-Border Services

If the Highways, Inc. group is planning to have one of its foreign nondomiciled entities render services to the Colombian entity so that the latter can perform under the public contract, it is important to determine the nature of the services and where they are physically rendered in order to be able to determine the applicable tax treatment.

Although the concept of a "permanent establishment" has not yet been introduced into the Colombian internal tax rules, Colombian commercial law provides that foreign nondomiciled entities undertaking "permanent activities" within Colombian territory are required to establish and perform such activities through a Colombian branch. The legal concept of permanent activities is broad, so that a case-by-case analysis has to be done in order to determine whether the Highways, Inc. group's foreign entity could be deemed to be undertaking permanent activities in Colombia. As a mere reference, performing activities in Colombia for a period greater than six months could be considered as performing permanent activities.

If the activities to be undertaken by the Highways, Inc. group's foreign entity do not qualify as permanent activities, the Highways, Inc. group must bear in mind that, as a general rule, services provided within Colombian territory generate Colombian source income subject to income tax.[36] This tax normally is collected by means of income tax withholding that must be applied at different rates, depending on the nature of the service. For example, payments for technical services, technical assistance and consultancy services are subject to a ten percent income tax withholding rate whereas payments for professional services are subject to a rate of thirty-three percent.[37] In both cases, withholding is applied on the gross payment or accrual. Additionally, services provided within Colombian territory are subject to VAT at a general rate of sixteen percent. This tax normally is collected through a reverse-charge mechanism according to which the beneficiary of the service (i.e., the Colombian entity) should directly pay the VAT to the Colombian government. This VAT (i.e., input VAT) may be credited against the VAT generated by the Colombian beneficiary when it renders services (i.e., output VAT) if certain requirements are met.[38] The VAT that is not creditable against the output VAT in accordance with Colombian law shall be treated as a higher cost of the goods and services acquired by the Colombian entity.

On the other hand, there are some services that are deemed to generate Colombian source income even if rendered outside Colombian territory (i.e., technical services, technical assistance and consultancy services).[39] Payments as consideration for these types of services are subject to income tax withholdings at a rate of ten percent, as previously mentioned. Likewise, technical assistance and consultancy services trigger VAT even when rendered outside Colombian territory to a Colombian beneficiary. This tax also is collected and paid to the Colombian government through a reverse-charge mechanism as explained above.

Payments for services should be one hundred percent tax deductible by the Colombian entity so long as the corresponding income tax withholding is applied.[40] In the case of payments that are not subject to income tax withholding because, for example, they are not deemed Colombian source income, they will be tax deductible up to an amount that does not exceed fifteen percent of the Colombian entity's taxable income calculated before such expenses are computed.

The Highways, Inc. group should also consider the possibility of rendering services to the Colombian entity through a subsidiary located in a DTT jurisdiction. In fact, it may occur that the income tax withholding to be applied by the Colombian entity on payments for services provided outside Colombia could not be credited in the foreign entity's home jurisdiction because, for example, such jurisdiction only allows a credit for foreign taxes accrued on foreign-source income. The DTTs entered into by Colombia may include rules limiting this kind of double taxation.

Finally, please consider the discussion above regarding the Colombian transfer pricing regime as it may apply to the rendering of services to the Colombian entity.

## Endnotes

1. Colombian Code of Commerce (CCC) §§ 471 and 474. The CCC expressly provides that an entity that has been granted a concession by the Colombian government is deemed to undertake permanent activities in Colombia. CCC § 474-5.
2. Colombian Tax Code (CTC) § 240.
3. CTC §§ 12, 13 and 14.
4. CTC § 12.
5. *Sociedades por Acciones Simplificadas* or simplified stock companies were incorporated into Colombian law by means of Law 1258 of 2008. Even though this type of entity shares most of its features with corporations, it has some flexible requirements; for example, corporations require a minimum of five shareholders while simplified stock corporations need only have one shareholder.
6. CTC § 12.
7. Section 10 and 13 of Law 1258, 2008.
8. CCC §§ 471 and 474.
9. As of December 2011, Colombia has entered into DTTs with Spain, Chile, Peru, Ecuador and Bolivia. The Colombian government has signed other DTTs but they have not yet come into force.
10. CTC §§ 12 and 24. Capital gains obtained by foreign investors from the sale of shares of Colombian companies are subject to income tax in Colombia, at a rate of thirty-three percent of the difference between the sale price and the tax basis of the shares.
11. CTC § 245, para. 1.
12. Section 13 of the Spain-Colombia DTT.
13. CTC § 124-2; § 408. As of December 2011, the Colombian government has not issued a tax haven blacklist. However, the Colombian government is willing to join the Organization for Economic Cooperation and Development (OECD), and, therefore, a blacklist is expected to be issued soon as it is a requirement to join such organization.
14. Please note that, even though there are no capitalization rules in Colombia, there are some restrictions regarding the full deductibility of interest. For example, Section 124-1 of the CTC provides that interest paid by a subsidiary to its parent will only be deductible if such interest has been subject to the Colombian transfer-pricing regime. Additionally, for Colombian tax purposes, debts acquired with foreign related parties are considered as equity of the Colombian debtor, in which case the minimum presumptive income is not reduced by the amount of such debts (CTC § 289). However, such rule is not applicable in the case of foreign creditors located in a jurisdiction with a DTT.
15. Boletin No. 43, amending Regulation DCIN-83, issued by the Colombian Central Bank. It should be noted that, before Boletin No. 43, under Colombian foreign exchange regulations, foreign lenders had to be financial institutions duly recognized by the Colombian Central Bank. Resolution 8 of 2000 and Regulation DCIN-83 issued by the Colombian Central Bank. In other words, under Colombian law no intercompany loans could be made if the lender was a foreign non-domiciled entity that had not been recognized as a financial institution. There were alternatives for foreign parents or foreign related entities to fund their Colombian subsidiaries via foreign debt (which is no longer needed after Boletin No. 43). One alternative was to enter into a back-to-back loan with a foreign financial institution which would be the one disbursing the loan proceeds. Immediately after disbursement, a "creditor substitution" would be carried out, as a result of which a member of the Highways, Inc. group would become the creditor.
16. CTC § 408.
17. CTC § 592-2. It is assumed that the entire lender's Colombian source income is subject to some of the income tax withholdings set forth under CTC §§ 407 to 411.
18. CTC § 260-1.
19. CTC §§ 450 and 452; CCC §§ 260, 261, 263 and 264.
20. Decree 650 of 1996.
21. CTC § 36.
22. Note that ordinary expenses incurred during pre-operating stages should be accounted for as a deferred expense that should be amortized and deducted once the entity generates taxable income.
23. Colombian taxpayers are not subject to the alternate income tax computation during their pre-operative stage. CTC § 189.
24. Tolls and contributions paid to the Colombian Government or to private entities when the Government has granted a concession are excluded from VAT. *See* Section 10 of Decree 1372 of 1992.
25. CTC § 870.
26. Section 6 of Law 1106 de 2006 as modified by Law 1421 of 2010.
27. See Law 223 of 1995, § 89.
28. See Law 1111 of 2006, § 66.
29. 5,000 monthly legal wages.
30. See Law 1450, § 48.
31. CTC § 24.
32. This treatment suggests that the leasing agreement is in fact a financing operation not very different from an ordinary loan and, as such, the lessee should account for a liability, as well as an asset, to reflect the fact that the asset under the leasing agreement is being controlled and used by the lessee. The booking of both the asset and the liability should be made for the value of the asset under the leasing agreement.
33. Once the lessee pays each periodical rental fee, the lessee must divide each rental fee into the portion pertaining to the financial yield and the portion pertaining to capital amortization. The financial yield portion would constitute an expense for accounting purposes, which would be deductible, provided that the asset participates in the income-producing activity of the lessee. The capital amortization portion should be used to reduce the liability accounted for upon execution of the contact. Finally, upon exercise of the purchase option, the strike price should be used to reduce the remaining balance of the liability initially recorded by the lessee. Once the strike price of the option is paid, the balance of the liability should be zero.
34. CTC §§ 420 and 476-3.
35. CTC §§ 121 and 121.
36. CTC § 24.
37. CTC § 408.
38. CTC §§ 485 and 488.
39. CTC § 24.
40. CTC §§ 121 and 123.

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# Utilizing Tax Incentives for Infrastructure Ventures in Latin America: The Mexican Perspective

By Mariana Eguiarte-Morett

## I. Introduction to Highway Infrastructure Projects in Mexico

President Calderon's "National Development Plan," prepared by his government, included infrastructure as an important part of the agenda. The National Infrastructure Program 2007-2012 derives from that National Development Plan. This program sets forth objectives, strategies, goals, and actions that must be carried out to increase the coverage, quality, and competitiveness of infrastructure in the country.[1]

Because the 2006-2007 report issued by the World Economic Forum had positioned Mexico in sixty-fourth place out of one hundred twenty-five countries in terms of its infrastructure competitiveness, the National Infrastructure Program was conceived as a way of improving the results of future reports.

A significant action that has been taken by President Calderon's government to incentivize infrastructure investments in Mexico (closely related to the National Infrastructure Program 2007-2012) has been a proposed Public-Private Partnership Law presented to Congress back in November, 2009 and approved in December of 2011. The purpose of the law is to regulate public and private investment in infrastructure projects and to provide legal certainty to potential private investors. It is expected that Mexico could substantially increase infrastructure competitiveness if the private sector finances the construction, maintenance, and operation of infrastructure projects through its own sources.

Concerning highway infrastructure, Mexico has generally adopted both the internationally known "private finance initiative" through the PPS[2] structure and the public-private partnership or PPP structure through a model designed by the Ministry of Communications and Transportation (known as the "Structure of Tolled Road Concession"). Under a PPS structure, the project is wholly financed by the private sector, and under the Structure of Tolled Road Concession the government contributes resources to finance the project.

A PPS structure in the context of highway infrastructure has generally the following characteristics:[3]

- A long-term service agreement is entered into between the private investor and the Mexican government. These service agreements are granted through public bidding processes;
- The private investor is engaged in the design, financing, operation, and maintenance so that the government renders a public service. The government makes periodical payments regarding effectively rendered services;
- The private investor must construct the infrastructure with its own assets or with assets owned by third parties, but it must always contribute the infrastructure;
- The private investor renders the services to the Mexican government while the Mexican government is directly liable for the rendering of the public service;
- The risk is shared between the Mexican government and the private investor, with each party thereby assuming the risk that can be better controlled or mitigated by that party. In all cases, the private investor takes the risk of the design, financing, operation and maintenance of the assets used to render the service;
- The Mexican government registers current expenses (i.e., the obligation to pay for services rendered by the private investor) rather than the assumption of public debt.

The Structure of Tolled Road Concession has generally the following characteristics:[4]

- Concessions are granted through public bidding processes;
- To ensure that tolls are compatible with users' willingness to pay, the government establishes the average maximum tolls to be charged on the highway and the rules for periodic updates according to inflation;
- The concession term is fixed, up to a maximum of thirty years, in accordance with the Roads, Bridges, and Federal Transportation Law;
- The government makes an initial contribution of public funds to each project;
- The government is committed to make a subordinate contribution, if necessary, to ensure payment of the credits used for the construction of the works;
- The project is adjudicated to the bidder who presents a technical and financial proposal that complies with the requirements established in the bidding documents and requests the smallest total amount of public funds or offers the highest consid-

eration payable to the government for the concession.

This article analyzes the general tax issues arising from a highway infrastructure project in Mexico under the facts and circumstances set forth in the case study. Firstly, the foreign investor (Highways, Inc.) must choose the appropriate investment vehicle, corporate structure, and SPV's capital structure (see Parts II, III, and IV). Secondly, the Mexican investment vehicle (SPV) will be subject to tax obligations in Mexico and will also benefit from certain tax incentives during the preoperative, construction, and operational stages (see Part V). Thirdly, the SPV will face other tax issues arising from the execution of the highway infrastructure project such as resolving who the owner of the construction equipment should be (see Part VI) and how to deal with cross-border services rendered during the project (see Part VII). The analysis contained in this article is not intended to be comprehensive, and, in some cases, it reflects the academic opinion of the author. It should also be noted that this article is based on the Mexican laws and regulations in force as of 10 January 2012.

## II. How to Invest in Mexico: the Choice of Investment Vehicle

Foreign entities intending to directly undertake business activities in Mexico (i.e., without incorporating a Mexican entity) must establish a branch.[5] The mere participation in a public bid should not be regarded as a business activity, and, therefore, it would be unnecessary to establish a branch merely for purposes of the bid.

However, concessions for the construction, exploitation, operation, and maintenance of federal roads and bridges can only be granted to Mexican individuals or entities incorporated under Mexican law.[6]

Highways, Inc. could participate directly in the public bid with no need of incorporating a Mexican entity or establishing a branch and without triggering any adverse tax consequence (such as being considered to have a permanent establishment in Mexico).[7] Typically, rights from public bids cannot be assigned to third parties, except upon authorization by the government to do so.[8] In the case of the Structure of Tolled Road Concession that has been recently implemented by the Mexican government as a mechanism for public-private partnerships in the area of infrastructure, the general instructions of the public bid typically provide that, if the government contract is granted, a special purpose vehicle (SPV) would have to be incorporated and, thereafter, the rights of the public bid would be assigned to the SPV.[9]

The SPV generally could be incorporated in any of the legal forms prescribed by law. The typical legal forms are *Sociedad Anónima* (S.A.) and *Sociedad de Responsabilidad Limitada* (S.R.L.).[10] The U.S. regards S.A.s as "per se corporations" and therefore not eligible for pass-through treatment while S.R.L.s could qualify for such treatment. Highways, Inc. could be better off incorporating an S.R.L. if its intention is to get current use of foreign losses, while it would be better off incorporating as an S.A. if its intention is to achieve income tax deferral (a thirty percent Mexican income tax rate versus a thirty-five percent or higher U.S. income tax rate). Highways, Inc. should succeed in achieving deferral given that the SPV would conduct an active trade or business in Mexico, and, therefore, the U.S. should typically not claim application of its Controlled Foreign Corporation rules.

It should be noted, however, that, in the case of the Structure of Tolled Road Concession, the general instructions of the public bid typically provide that the SPV is required to be incorporated in the form of an S.A. without any possibility of choosing a different legal form.[11] What is more, S.R.L.s cannot issue bonds and place them in the local public market.

There is no restriction regarding foreign investment pertaining to the construction, operation, and maintenance of highways in Mexico.[12] Therefore, the SPV could be held by Highways, Inc. with no further restrictions, except for the fact that the law forbids the incorporation of entities held by only one shareholder or partner.[13]

Should Highways, Inc. intend to participate with a local party in the infrastructure project, it could enter into a joint venture agreement whereby both entities agree to incorporate an independent domestic SPV from the outset to participate in the public bid. The general instructions of a public bid designed under the recent Structure of Tolled Road Concession generally allow making the incorporation of the SPV subject to the condition that it be awarded the government agreement.[14]

Alternatively, Highways, Inc. could participate with a local party in the public bid through a consortium, thereby presenting joint offers. If the consortium wins the bid, Highways, Inc. and the local party could jointly incorporate an independent domestic SPV to execute the government agreement and hold the concession, thereby participating in such SPV in the proportion established within the joint offer. This is also typically provided for in the general instructions of a public bid designed under the recent Structure of Tolled Road Concession.[15]

Another option is for the local party to participate in the public bid and merely subcontract Highways, Inc. to render services related to the project. The local party would execute the government agreement and hold the concession while Highways, Inc. would act as a mere subcontractor for the local entity. It should be noted that the local party would be obliged to carry out directly the essential activities involved in the execution of the government agreement because otherwise it would be materially assigning the rights arising from the public bid

to Highways, Inc., and rights from public bids cannot be assigned to third parties. Therefore, the scope of work for Highways, Inc. (as subcontractor) would be limited.

## III. Choice Between Investing Directly and Interposing an Investment Jurisdiction

### A. Direct Investment

Mexico currently has forty-two Double Taxation Treaties (DTT) in force, including a DTT with the U.S.[16]

The SPV could be incorporated directly by Highways, Inc. and take advantage of the U.S.-Mexico DTT when payments are made by the SPV to Highways, Inc. For example, service fees (arising from the rendering of independent professional services) are subject to a twenty-five percent domestic withholding rate, but, if paid to an entity resident in a tax treaty partner (like Highways, Inc.), those fees would qualify for no withholding tax rate at source (i.e., Mexico) upon application of the U.S.-Mexico DTT.[17]

The case study assumes that Highways, Inc. is a corporation in the U.S. and, therefore, the application of the U.S.-Mexico DTT is unquestionable. However, even if the U.S. entity were a Limited Liability Company and it received tax transparency treatment for U.S. purposes, the benefits of the U.S.-Mexico DTT would still apply, provided that the Mexican-source income was subject to tax as the income of a U.S. tax resident according to the Mutual Agreement entered between Mexico and the U.S. of December 2005 (the "Mutual Agreement"). Indeed, under the Mutual Agreement, if Mexican source payments are made to a U.S. entity that is treated as fiscally transparent for U.S. tax purposes, reduced DTT withholding tax rates will only be available if the U.S. taxes the entity's members on such income as U.S. tax residents and in proportion to the members' participation in such entity.

### B. Investment Jurisdiction

As a matter of tax planning for an exit strategy, a non-Mexican tax resident entity could be interposed between the SPV and Highways, Inc.

From a Mexican tax-efficiency standpoint, this would open up the possibility of having Highways, Inc. sell its shares of the intermediary entity rather than directly of the SPV. Mexico only taxes at source the transfer of shares issued by Mexican tax resident entities or shares the value of which is represented in more than fifty percent (directly or indirectly) of Mexican real property.[18] Mexico would not tax the sale of shares of the non-Mexican tax resident intermediary entity considering that the concession is regarded as personal property rather than real property under law.[19]

The intermediary entity could be either a U.S. tax resident or a tax resident of a country having a DTT with the U.S. that foregoes taxation at source upon the sale of the entity's shares. In the latter case, the proposed structure would also need to be tax-efficient both from a U.S. tax standpoint and from the perspective of the intermediary entity's country of residence. A participation exemption regime would be preferred to the extent that any dividends flowing from the SPV to the intermediary entity and from the intermediary entity to Highways, Inc. would be tax-free. Additional comments apply from a U.S. tax standpoint pertaining to the feasibility of this exit strategy, particularly with regard to the tax treatment in the place of residence applicable to the transfer by Highways, Inc. of its shares in the intermediary entity and also with regard to the potential application of U.S. rules pertaining to controlled foreign corporations on a corporate structure like the one proposed.

A tax-efficient structure where a two-tier chain of intermediary entities (i.e., where the first-tier entity holds the second-tier entity) is interposed between the SPV and Highways, Inc. might also be available depending on the tax residence of each entity, the availability of participation exemption regimes, and the particular tax benefits provided in the applicable DTTs (e.g., a corporate structure allowing dividends to flow tax-free from the SPV up to the two intermediary entities and then to Highways, Inc., and also allowing the transfer of shares done by the first tier-entity of its shares in the second-tier entity to be tax-exempt both at residence and source). From a U.S. tax standpoint, controlled-foreign-corporation rules would need to be analyzed to determine the feasibility of the strategy.

Alternatively, the intermediary entity could sell the shares of the SPV and claim the benefit of the DTT between Mexico and its country of residence. A planning strategy like this could be useful, instead of having Highways, Inc. sell the shares of the intermediary entity, to the extent that it is feasible to defer U.S. capital gains tax because the capital gains tax at the intermediary entity's country of residence is lower than that in the U.S. Also, the capital gains tax rate provided in the DTT between Mexico and the intermediary entity's country of residence should be beneficial. The Netherlands-Mexico DTT is a good example because Mexico would only tax capital gains at ten percent of the net proceeds, and the Netherlands should not tax capital gains under its participation exemption regime.

## IV. SPV's Capital Structure

### A. Equity

Dividends distributed by Mexican tax resident legal entities (i.e., the SPV) must either have been subject to income tax previously or be subject to income tax at the moment of distribution. Mexico follows an integrated system of taxation, whereby corporate profits are only taxed once at the corporate level. Dividends paid to the equity investor (i.e., Highways, Inc.) would not be subject to an

additional withholding tax rate, regardless of the investor's country of tax residence.[20]

### B. Debt

#### 1. Interest Payee

Interest paid by Mexican tax resident legal entities (i.e., the SPV) is sourced in Mexico.[21]

#### (a) Traditional Loans

If interest is paid on traditional loans granted by non-Mexican tax-resident financial institutions, the applicable withholding rate could be 4.9% (if the bank is registered with the Foreign Bank Registry and is a tax resident of a tax treaty partner),[22] a reduced DTT withholding tax rate (if the bank is not registered with the Foreign Bank Registry and is a tax resident of a tax treaty partner),[23] ten percent (if the bank is registered with the Foreign Bank Registry and is not a tax resident of a DTT partner),[24] or thirty percent (if the bank is not registered with the Foreign Bank Registry and is not a tax resident of a DTT partner).[25] Import VAT would be triggered on the interest charges, but there would be no economic impact on the interest payee or the interest payer. VAT arising from the import of services (as in this case) works as a "virtual" entry from the interest payer (Highways, Inc.) because, on the one hand, the interest payer is subject to import VAT on the import of services (which is the "virtual" input VAT), and, on the other, the interest payer has the right to a credit for it (which is the "virtual" output VAT) in the same monthly return; thus, there is a net effect of "zero," as illustrated by A – B in the following example:[26]

| | | | |
|---|---|---|---|
| *Interest (value of the service)* | $100,000 | *Interest (value of the service)* | $100,000 |
| *Tax rate* | 16% | *Tax rate* | 16% |
| *"Virtual" input VAT on the import of services* | $16,000 **(A)** | *"Virtual" output VAT on the import of services* | $16,000 **(B)** |

If interest is paid on traditional loans granted by non-Mexican tax residents (not financial institutions), the applicable withholding tax rate would usually be fifteen percent if the lender is a tax resident of a tax treaty partner[27] or thirty percent if the lender is not a tax resident of a tax treaty partner.[28] The withholding tax rate would be forty percent if the lender is a related party to the interest payer, the lender is a tax resident of a tax haven jurisdiction, and such jurisdiction has not entered into a comprehensive exchange of information agreement with Mexico.[29] Import VAT would be triggered on the interest charges, but there would be no economic impact on the interest payee or the interest payer, pursuant to the same reasoning described in the preceding paragraph.[30]

If interest is paid on traditional loans granted by a Mexican tax-resident financial institution, the financial institution would be subject to income tax on the interest income and to a flat tax[31] on the intermediation margin (i.e., the difference between the interest receivable and the interest payable).[32] VAT would not be triggered on the interest charges.[33]

If interest is paid on traditional loans granted by a Mexican tax resident (that is not a financial institution), the lender would be subject to income tax on the relevant interest income. VAT would be transferred to the SPV on the interest charges.[34]

#### (b) Bonds

If the SPV (incorporated in the form of an S.A.)[35] issues bonds on the Mexican stock exchange, non-Mexican tax resident bondholders would be subject to a 4.9% withholding tax rate on interest, provided that certain conditions are met.[36] If those conditions are not met, a ten percent withholding tax rate would apply.[37] A thirty percent withholding tax rate would apply instead if the effective beneficiaries, directly or indirectly, individually or jointly with related parties, receive more than five percent of the interest paid on the bonds and (1) own directly or indirectly, individually or jointly with related parties, more than ten percent of the voting stock at the SPV; or (2) are entities twenty percent or more of whose stock is owned directly or indirectly, individually or jointly, by parties related to the SPV.[38]

If the bondholders are Mexican tax residents, they would be taxed on the relevant interest income. No VAT would be triggered.[39]

The issuance of bonds to finance the project could be supported by the securitization of the net present value of future collection rights.

#### 2. Interest Payer

The SPV generally would be able to deduct interest for income tax purposes to the extent that (1) interest is agreed to at arm's length and evidence of such circumstance is retained;[40] (2) thin capitalization rules are met (i.e., a three-to-one debt-to-equity ratio must be maintained);[41] (3) it withholds and pays the appropriate income tax from the payment to the interest payee;[42] (4) it invests the borrowed funds for purposes of the business; (5) it agrees to the same or a higher interest rate if it uses the borrowed funds to grant loans; and (6) it timely files certain information returns with the Tax Administration Service.[43] Requirements described in items (1) and (2) only apply to the deductibility of interest paid by the SPV to Highways, Inc. because both are related parties, and Highways, Inc. is a non-Mexican tax resident.

Concerning VAT, the relevant consequences depend on the nature of the lender (i.e., whether it is a non-Mexican tax resident financial institution, a non-Mexican tax resident, a Mexican tax resident or a Mexican tax resident financial institution). (See Part 1 above for more details.)

Interest will not be deductible for flat tax purposes regardless of whether it is paid to related or independent parties.[44] The foregoing could trigger important differences between the taxable basis for flat tax purposes and the taxable basis for income tax purposes, thereby triggering a significant risk of increasing the SPV's effective tax rate in Mexico. See Part V.C for information on flat tax.

## V. Tax Treatment of the Infrastructure Project in Mexico

### A. Preoperative Stage

#### 1. Preoperative Expenses

Preoperative expenses are deductible at a ten percent rate per year, unless they relate to benefits realized in the same tax year.[45] As a general rule, input VAT can only be credited against output VAT when input VAT paid by the taxpayer is related to activities subject to VAT. It is possible, however, to recover input VAT incurred in a preoperative stage regardless of the fact that the activities subject to VAT have not been performed yet. Input VAT paid in a preoperative stage on investment and expenses may be credited pursuant to an estimate made by the taxpayer of the activities that will be subject to VAT after the preoperative stage.[46]

#### 2. Federal Tax Exemptions and Tax Holidays; Legal and Tax Stability Agreements

There are generally no federal tax exemptions or tax holidays in Mexico. Also, there are no legal and tax stability agreements, but the government assumes a portion of the legal risk in infrastructure projects.

#### 3. Government Grants

The Federal Government, through Promexico,[47] created a fund in 2009 to support major foreign investment projects and strategic investment projects (including infrastructure, buildings and construction). Eligible projects of foreign entities or Mexican entities with a majority of foreign participation can receive government financial grants of up to (i) five percent of the total cost of the project, in major projects; or (ii) ten percent of the total cost of the project for strategic projects.[48]

The Federal Government also created the National Fund of Infrastructure (known by its Spanish acronym, "Fonadin") in 2008 as a mechanism for implementing the National Infrastructure Program. Fonadin grants both recoverable and nonrecoverable grants under particular circumstances and provided several requirements are met.[49]

#### 4. Local Taxes

Some states of the Mexican Republic have issued specific laws for public-private partnerships that provide benefits for private investors. Payroll tax exemptions could be negotiated with governments of the states where the highway project is executed if certain requirements are met (e.g., establishing a domicile in the state and creating jobs). Also, real estate tax exemptions could be negotiated with the governments of the states and municipalities involved on a case-by-case basis.

#### 5. Profit Sharing

Employers are compelled to provide profit sharing to their employees at the rate of ten percent of their taxable profit. Profit sharing is deductible in the year it is paid.[50] Newly incorporated companies are not obliged to pay profit sharing during the first year of operation.[51]

#### 6. Thin Capitalization Rule

There are no specific thin capitalization rules for highway projects, but through the negotiation of an "advanced pricing agreement" it is possible to apply for an extension of the three-to-one leverage threshold if the taxpayer is able to demonstrate that the activities performed demand higher leverage.[52]

### B. Construction Stage

#### 1. Consideration Paid for Concessions

Typically, concessions are granted to private investors for a consideration divided into two types of payments: (1) an initial payment for the granting of the concession, and (2) annual payments for the exploitation of the concession. The initial payment qualifies as an investment (and is a deferred expense) and must be amortized proportionally during the life of the concession.[53] Annual payments qualify as deductible expenses in the corresponding year.[54]

#### 2. Special Features in Construction Tax Regimes

There are special features in construction tax regimes that would also apply to the highway project. Taxpayers involved in construction projects are allowed to defer the accrual of income until they effectively collect payment, provided that collection occurs more than three months after the date in which the estimates for executed works are approved for payment.[55]

Taxpayers involved in building real estate projects or executing an agreement for the construction of immovable property also are allowed to deduct estimated expenses related to the direct and indirect cost of the works. Such estimated expenses are calculated through a deduction factor. At the end of the project, taxpayers that opted to apply this benefit must review whether there is a difference between the estimated deductions and the actual deductions and must pay the difference in income tax, if

any, thereby also paying surcharges if the estimated deductions exceeded five percent of the actual deductions. Taxpayers must file a notice with the tax authority to take advantage of this option.[56]

### 3. Special Rules for Investments in Public Works

A taxpayer will be eligible to apply special rules for depreciation of investments under the following conditions: (1) the taxpayer is granted a concession for the construction, operation, and maintenance of public works (e.g., a highway); (2) the investment in construction or installations done for the construction, operation, and maintenance of public works is not financed by the government or, if it is financed by the government, then the value of the investment for depreciation purposes must be reduced by the amount of the government contribution (i.e., taxpayers are only entitled to depreciate investments in the amount that has been effectively financed by them); and (3) the construction or installations must revert in favor of the government once the term of the concession elapses.[57]

Under the general depreciation rules, the taxpayer would be able to depreciate the investment by applying regular rates for the straight-line depreciation method (e.g., five percent yearly for construction, thus requiring twenty years of concession to depreciate one hundred percent of the investment) or for the accelerated depreciation method.[58] Under the special depreciation rules, the taxpayer will be able to choose between (1) the straight-line depreciation method by using rates adjusted to the number of years of the concession instead of the regular rates (e.g., ten percent yearly where concession was granted for ten years, 3.33% yearly where concession was granted for thirty years);[59] (2) the regular accelerated depreciation method (e.g., eighty-five percent for industrial construction);[60] or (3) the accelerated depreciation method by using adjusted rates (e.g., ninety-four percent where the concession is granted for one year, seventy-four percent where the concession is granted for ten years, forty-six percent where the concession is granted for thirty years).[61]

In addition, a taxpayer applying the accelerated depreciation method (either regular, or adjusted), will be entitled to take the deduction for purposes of calculating estimated monthly income tax payments. Note that under regular circumstances, taxpayers should consider nominal income (i.e., income for which no deductions are allowed) when calculating the estimated monthly payments.[62]

Where the Mexican government has contributed funds to finance the infrastructure project and the taxpayer applies the special depreciation rules to the value of the investment effectively financed by the taxpayer (i.e., the original amount of the investment minus the government contribution), such taxpayer may also opt to exclude government contributions as debt for computing inflationary income if the taxpayer does not keep the right to participate in the revenues of the concession or the taxpayer's participation begins when the concession finishes and the taxpayer has complied with all payment obligations agreed to in the concession (including reimbursement of the venture capital contributed by the government and its yields). The taxpayer will additionally be allowed not to consider government contributions as accruable income if the taxpayer does not take a deduction of the inflationary effect arising from not having considered such contributions as debt for computing inflationary income.[63]

### 4. Special Rule on the Amortization of NOLs

A taxpayer being eligible to apply special rules for depreciation of investments (as described in the preceding Part V.B.3) will also be eligible to amortize the NOLs arising from the exploitation of the concession during the life of the concession rather than during the regular ten fiscal year carryforward period.[64]

### 5. Other Investments

Investments can be amortized for income tax purposes either through the regular straight-line depreciation method, where the taxpayer depreciates the asset over time by applying the relevant percentage provided by law, or under an accelerated depreciation method, where the taxpayer is allowed to take an immediate deduction of the cost of the fixed asset at a reduced rate. Accelerated depreciation is not available for certain assets, such as office equipment and supplies, certain automobiles and aircraft. It is generally available for fixed assets used permanently within Mexican territory, excluding the Federal District, Guadalajara and Monterrey (the latter restriction does not apply if a taxpayer adopts environmental measures and the activities performed are low water consuming).[65]

Fixed assets would be deductible on a cash basis for flat tax purposes. The timing difference between income tax and flat tax should not lead to undesirable consequences because, while there would be a taxable basis for income tax purposes, there also would be NOLs for flat tax purposes that can be carried forward over the following ten fiscal years.

## C. Operational Stage

### 1. Interaction Between Income Tax and Flat Tax

The flat tax entered in force on 1 January 2008 and replaced the asset tax. The main attributes of the flat tax are as follows: (1) minimum exemptions; (2) a low rate; and (3) the deductibility of expenses necessary to create income. Taxpayers must also calculate both income tax and flat tax and pay the higher of the two. The following chart shows interaction between income tax and flat tax calculations:

| | Income Tax | Flat Tax |
|---|---|---|
| **Purpose of tax** | Taxes net profits and is levied on an *accrual basis* | Taxes the return of investment on production factors and is levied on a *cash basis* |
| **Rate** | 30% for 2010 to 2012, 29% for 2013 & 28% for 2014 and thereafter | 17.5%, but, as part of its phase-in, the rate was reduced to 16.5% for 2008 and 17% for 2009 |
| **Taxable Income** | Income from whatever source derived received in cash, kind, services or credit, inflationary gain-loss, and exchange rate gain-loss | Income from the sale of goods or services and leasing or letting the use of assets of any kind |
| **Deductions** | Business expenses that are strictly indispensable to the development of the taxpayer's business, gradual depreciation or amortization of investments, and COGS for inventories | Business expenses, investments, and inventories all fully deductible upon payment thereof |
| **Nondeductible items** | | Interest paid by independent or related parties, royalties paid by related parties, payroll (tax credit granted instead), labor benefits |
| **Annual calculation** | Taxable Income<br>(-) Deductions<br>(-) Mandatory profit sharing payments<br>(-) NOLs<br>**BASE / PROFIT**<br>* Rate (30% for 2011)<br><br><br><br><br><br>(-) Estimated monthly Income Tax payments<br>**INCOME TAX FOR THE YEAR** | Taxable Income<br>(-) Deductions<br><br><br>**BASE**<br>* Rate (17.5% as of 2011)<br>**FLAT TAX DUE**<br>(-) Credits of deductions in excess of income (equivalent of NOLs)<br>(-) Credits for salaries and social security contributions for the year<br>(-) INCOME TAX FOR THE YEAR<br>**FLAT TAX FOR THE YEAR**<br>(-) Estimated monthly FLAT TAX payments<br>**PAYMENT OF BALANCE OR FAVORABLE BALANCE** |

The flat tax was also conceived as an alternative minimum tax although it has more of an impact as an additional tax. Indeed, the total tax burden increases where, given the structural differences between the income tax and flat tax, the taxable profit for flat tax purposes turns out to be higher than the taxable profit for income tax purposes. In such case, the taxpayer pays the flat tax on the excess portion of taxable profit and it cannot recover such tax or apply it as a credit in the future. The main structural differences between the income tax and the flat tax are as follows:

(1) The flat tax is assessed on a cash-flow basis, while the income tax is assessed on an accrual basis meaning that the moment of income and expense recognition could be different for purposes of each tax; and

(2) Certain deductions are allowed only for income tax purposes and are denied for flat tax purposes, i.e., interest (whether paid to related or independent parties),[66] royalties paid to related parties,[67] salary payments,[68] social security contributions, and social welfare fringe benefits.

Even though salary payments and social security contributions are not deductible for flat tax purposes,[69] taxpayers are entitled to take a tax credit, provided that such payments are subject to income tax in the hands of the payee ("salaries tax credit"). The salaries tax credit is calculated by multiplying the factor 0.175 by the sum of (i) social security contributions paid in Mexico for the relevant tax year, plus (ii) salary payments, assimilated salary payments, and in general any payment made by the employer to the employee as consideration for the subordinated services. The salaries tax credit is applied after the NOL tax credit and it cannot be carried forward for ensuing fiscal years, which means that the taxpayer could eventually lose the right to take the salaries tax credit if it has an NOL tax credit.[70]

As a general rule, social welfare fringe benefits are not deductible concepts for flat tax purposes, and they cannot be included on the salaries tax credit because they are income tax-exempt items of income for employees.[71]

The flat tax will not be an issue to the extent that (1) the taxpayer balances properly the interaction between cash flow of income and deductions; and (2) the taxpayer manages expenses that are only deductible for income tax purposes. This is to make sure that the taxable profit subject to income tax is always higher than the taxable profit subject to the flat tax, so that an additional tax (i.e., flat tax) is not triggered. In a nutshell, a difference in the taxable profit of both taxes might occur as follows:

(1) If the taxpayer deducted an item for income tax purposes that is not deductible for flat tax purposes (i.e., royalties paid to related parties or interest);

(2) If the taxpayer recognized as income a cash inflow for flat tax purposes that had already been accrued for income tax purposes in a previous tax year (e.g., when the taxpayer issues an invoice to recognize the income in 2010 and it does not receive payment until 2011);

(3) If the taxpayer recognized a deduction upon a cash outflow for flat tax purposes that is deducted on an accrual basis for income tax purposes in the following years;[72]

(4) If the taxpayer deducted salary payments or social security contributions for income tax purposes and the salaries tax credit is lost because the taxpayer has an NOL tax credit;

(5) If the taxpayer deducted social welfare fringe benefits for income tax purposes that could not be credited for flat tax purposes because such payments are income tax-exempt items of income for employees.

The following example shows how the effective tax rate increases if a proper balance between the taxable profit for income and flat tax purposes is not achieved, as well as how the effective tax rate remains the same if such balance has been achieved.

| | **Without achieving balance** | | **Where balance is achieved** | |
|---|---|---|---|---|
| | *Income Tax* | *Flat Tax* | *Income Tax* | *Flat Tax* |
| Taxable profit | 100 | 300 | 100 | 100 |
| Nominal tax rate | 30% | 17.5% | 30% | 17.5% |
| Tax due | 30 | 52.5 | 30 | 17.5 |
| Final tax due | 30 | 22.5 (52.5 – 30) | 30 | 0 (17.5 – 17.5) |
| Effective tax rate | 52.5 / 100 = **52.5%** | | 30/100 = **30%** | |

During the operational stage, the SPV will be subject to income tax and flat tax obligations. If the SPV is granted the right to collect toll fees in the relevant concession, such toll fees would qualify as accruable income both for income tax and flat tax purposes. As mentioned above, for income tax purposes income is recognized on an accrual basis while for flat tax purposes income is recognized on a cash-flow basis. However, at least concerning the collection of toll fees, there would typically be no temporary difference arising from the moment of income recognition because toll fees would be collected and accrued at the same time for both income tax and flat tax purposes.

Under a PPS model, it could well be the case that the SPV acts as a mere collector of the toll fees and receives a consideration from the Mexican government for the management of the highway. The SPV would also be subject to income tax and flat tax obligations in this case concerning the accrual of its fees, but in this case the moment of income recognition could be different if the fees are collected from the government after being invoiced.

Aside from the income tax and flat tax treatment of toll fees, note that it will depend on the facts and circumstances of the SPV whether the interaction between income tax and flat tax results in increasing its effective tax burden.

### 2. Other taxes

If the SPV is granted the right to collect toll fees and it collects them in cash, it could be subject to a three percent cash deposits tax on the cash deposits to its bank accounts exceeding fifteen thousand Mexican pesos (approximately U.S. $1,110), either as a single deposit or in the aggregate of all deposits.[73]

Toll fees would be subject to VAT that must be transferred to the user of the highway.

## VI. Ownership of Construction Equipment

### A. Ownership by the SPV

If purchased by the SPV, the equipment would be depreciated over time under a straight-line depreciation method for income tax purposes and deducted immediately upon payment for flat tax purposes.[74] An isolated analysis of the equipment purchase leads to the conclusion that the timing difference between income and flat taxes should not lead to undesirable consequences because, while there would be taxable basis for income tax purposes, there would also be NOLs for flat tax purposes that can be carried forward over the following ten fiscal years.

If the equipment is purchased abroad and thereafter imported on

a permanent basis, the SPV would pay VAT and import duties and countervailing duties, if applicable, upon the importation.[75] VAT triggered upon the importation would be regarded as an input tax, thereby being creditable for the SPV against output VAT charged to its customers.[76] In this scenario, the SPV would not be able to import the equipment on a temporary basis.

### B. Ownership by Highways, Inc.

If the equipment is purchased by Highways, Inc., the SPV would have to pay an arm's length rental fee to Highways, Inc. because the entities are related parties.[77] The equipment would be regarded as industrial, commercial, or scientific equipment under the royalty definition as provided both by law and by the U.S.-Mexico DTT.[78] The twenty-five percent domestic withholding rate would be reduced to ten percent under the U.S.-Mexico DTT.[79] The lease payment would be deductible for income tax purposes on an accrual basis and for flat tax purposes on a cash flow basis.[80]

Highways, Inc. could purchase the equipment in Mexico or abroad. If purchased abroad and thereafter imported, SPV would have to register with the importers' registry and become the importer of record at the Mexican General Customs Administration. In such case, the equipment also would have to be imported on a permanent basis, and the applicable VAT, import and countervailing duties, as the case may be, would have to be paid. No temporary importations are allowed under this scenario.

The lease payment would be exempted from VAT because the lessor (Highways, Inc.) would be a non-Mexican tax resident, provided that import VAT was paid upon import of the equipment in Mexico.[81]

From a pure Mexican tax perspective, it seems more efficient for the SPV to own the equipment, having purchased it within Mexican territory, because otherwise Highways, Inc. would be subject to income tax in Mexico on the rental fees received. From a global perspective, if U.S. tax considerations are also analyzed, the conclusion might be different (e.g., the group might be better off by having Highways, Inc. receive rental payments if it is in a loss position in the U.S. even if it could not take a foreign tax credit on the income tax withheld in Mexico).

## VII. Cross-Border Services Rendered During the Project

### A. Introduction

If Highways, Inc. (or any of its subsidiaries or affiliates) renders services to the SPV, the tax treatment will depend on the nature of the services and on whether those services are rendered abroad or within Mexican territory. The tax issues ought to be analyzed from the following three perspectives: (1) Highways, Inc. (whether it could be deemed to have a level of permanent establishment exposure in Mexico); (2) the SPV (if Highways, Inc. is not regarded as having a permanent establishment or if the relevant income is not attributable to the permanent establishment, withholding tax rates might apply depending on their nature and on whether the services are deemed sourced in Mexico); and (3) the personnel of Highways, Inc. through which Highways, Inc. renders services to the SPV.

### B. From the Perspective of Highways, Inc.

#### 1. Construction and Maintenance Stage

Both under law and the U.S.-Mexico DTT, a building site or construction or installation project, or supervisory activity in connection therewith triggers a permanent establishment for non-Mexican tax residents if such services last more than six months.[82]

Mexico follows OECD Commentaries to interpret its treaties. Pursuant to the OECD Commentaries, the term "building site or construction or installation project" includes not only the construction of buildings but also the construction of roads, bridges or canals, the renovation (involving more than mere maintenance or redecoration) of buildings, roads, bridges or canals, the laying of pipelines and excavating and dredging. On-site planning and supervision of the erection of a building are also covered. Therefore, during the construction and maintenance stage of the highway, Highways, Inc. could be regarded as having a permanent establishment in Mexico if it renders, for more than six months, on-site planning and supervision services, or other services within Mexican territory and concerning the construction of the highway.

#### 2. Operational Stage

Regarding the operational stage, general rules of taxation should apply. Indeed, under general rules, having employees from Highways, Inc. travel extensively in Mexico could lead to permanent establishment exposure, because such entity would be rendering services to the SPV through its own employees and within Mexican territory. A service agreement in which a market fee is agreed would have to be entered into between Highways, Inc. and the SPV (because they are related parties).[83] The fee would be attributable to the permanent establishment of Highways, Inc. in Mexico, but there is also a risk of having the Mexican authorities claim more income attributable to such permanent establishment under the "force of attraction" principle.[84]

The level of permanent establishment exposure in this case would depend on the facts and circumstances (i.e., whether Highways, Inc. is given access to the SPV's facilities to the extent that such facilities are deemed a "place of business," and whether the number of days that Highways, Inc. is present in Mexico through its employees results in a "fixed" place of business in Mexico).[85] The risk could be managed through a secondment agreement between Highways, Inc. and the SPV.

### C. The SPV's Perspective

#### 1. Withholding Rates

#### (a) General Concepts

Revenues from the rendering of professional services are those that are paid in consideration of an independent personal service and that are not regarded as revenues from the rendering of subordinated personal services (i.e., salaries).[86]

Technical assistance is the rendering of independent personal services by which the party rendering it undertakes to provide nonpatentable knowledge—which does not imply the transmission of confidential information—regarding industrial, commercial, or scientific experience (i.e., know-how), such that the service provider undertakes the obligation to the service beneficiary to apply such knowledge. If an independent personal service meets these qualifications, the relevant payment ought to be regarded as revenue from technical assistance.[87]

Royalties are payments of any kind made for the temporary use or enjoyment of patents, certificates of invention or improvement, trademarks, trade names, copyrights for literary, artistic or scientific works, as well as drawings or models, plans, formulas or industrial, commercial or scientific procedures and equipment, and the amounts paid for the transfer of technology or information relating to industrial, commercial or scientific experience (i.e., know-how or the transfer of technology), or any other similar right or property.[88]

#### (b) Domestic Withholding Tax Rates

Depending on the facts and circumstances, Highways, Inc. (and any of its subsidiaries or affiliates) could render independent personal services or technical assistance (show-how), transfer technology (know-how), or a combination of all of these.

The source of revenues from fees and generally from the rendering of independent personal services is deemed to be in Mexico if the service is rendered within Mexican territory.[89] Unless otherwise proved, the service is deemed rendered in Mexico if the payments for it are made by a Mexican tax resident to a non-Mexican tax resident that is regarded as a related party under law.[90] Indeed, to the extent service fees are sourced in Mexico either because the services have been in fact rendered within Mexican territory or because such presumption has not been rebutted, income tax will be due and payable in Mexico generally at a twenty-five percent withholding rate applicable to the gross service fees.

Revenues from a transfer of technology (i.e., royalties) or technical assistance are deemed sourced in Mexico if paid by a Mexican tax resident or by a permanent establishment of a non-Mexican tax resident. If the revenues from transfer of technology (royalties) or technical assistance are sourced in Mexico, the Mexican tax resident payer or the permanent establishment, as the case may be, must withhold twenty-five percent of the gross payment.[91] As opposed to the treatment of service fees, payments in regard to technical assistance and transfers of technology (royalties) are sourced in Mexico merely because the payer is a Mexican tax resident or a permanent establishment of a non-Mexican tax resident, regardless of whether the technical assistance or transfer of technology has been rendered within Mexican territory or not.

#### (c) DTT Reduced Withholding Rates

The U.S.-Mexico DTT would apply to reduce domestic withholding rates to the extent that a U.S. tax resident is the effective beneficiary of the relevant payments. If the beneficiary of the payments resides in another country, the availability of reduced withholding rates will depend on the enforceability of a DTT between Mexico and the relevant country.

The consideration paid for independent personal services or technical assistance is regarded as business income and is thus not taxed by the source country (Mexico) under the U.S.-Mexico DTT, provided that such consideration is not paid for information concerning industrial, commercial or scientific experience (i.e., know-how). As such, the income received from the rendering of independent personal services or technical assistance will be taxable in Mexico only if the provider of the service has a permanent establishment located in Mexico through which such a service is rendered.[92]

Payments obtained in consideration of transfers of technology or information concerning industrial, commercial, or scientific experience are royalties under the U.S.-Mexico DTT. The source country (Mexico) would be entitled to a ten percent withholding tax rate, instead of the general twenty-five percent withholding rate foreseen under domestic law.

#### 2. Other Issues

#### (a) VAT

The SPV technically would be obliged to pay VAT under the concept that services were imported when it took advantage of the services rendered by Highways, Inc. in Mexico.[93] Also, the SPV would technically be obliged to pay VAT under the concept that intangibles were imported when it received know-how from a non-Mexican tax resident (i.e. Highways, Inc.).[94] However, the economic effect of this tax is neutralized because the importer of services (i.e., the SPV) triggers the VAT upon the importation and credits it in the same monthly return, thereby effectively paying zero VAT.[95] The VAT effect will be neutralized only to the extent that the services rendered by Highways, Inc. are regarded as "strictly essential" for the SPV to conduct activities burdened by this tax.[96]

### (b) Income Tax and Flat Tax Deductions; VAT Creditability

The SPV would generally be able to deduct the service fees and technical assistance fees for both income and flat tax purposes and credit the VAT triggered upon the importation of services (thereby reaching a net effect of zero VAT) to the extent that the fees are regarded as "strictly essential" expenses[97] and evidence exists as to the fact that the services and technical assistance were materially rendered or provided by Highways, Inc.[98] The same applies for payments under the know-how (royalties) concept pertaining to income tax and VAT; however, arguably, royalties would not be regarded as deductible expenses for flat tax purposes to the extent that they are paid to related parties (i.e., Highways, Inc.).[99]

Certain formal requirements for the deductibility of the service fees, technical assistance fees, and royalties also must be met. These requirements include having the SPV withhold the appropriate income tax to Highways, Inc. (if applicable),[100] file information returns on payments made to Highways, Inc.,[101] and obtain and retain evidence demonstrating that Highways, Inc. has the technical wherewithal to render the relevant services, technical assistance, or transfer of technology.[102] Regarding the latter, the evidence must also show that Highways, Inc. rendered the services directly and not through a third party.

Given that Highways, Inc. and the SPV are related parties,[103] the relevant fees would need to be agreed to on an arm's length basis.[104] Evidence of such circumstance must be retained.[105]

## D. Personnel of Highways, Inc.

### 1. Individual Tax Residence

It must be analyzed whether the individuals will remain tax residents of their country of residence (be it the U.S. or others) or whether their level of presence will amount to a change of tax residence to Mexico. This will depend on the facts and circumstances relating to each individual. For example, if they retain their permanent home, bank accounts, and personal and professional relations in their country, they will typically continue being tax residents there and pay taxes in Mexico only on their Mexican-source income.

Individuals are considered Mexican tax residents if they establish their home in Mexico. In the event that they have also established a home in another country, they will be considered Mexican tax residents if their "center of vital interest" is located in Mexico (i.e., if more than fifty percent of the total income obtained by the individual in a calendar year is Mexican-source income or if their principal center of professional activities is located in Mexico). Income paid for services provided in Mexican territory is deemed to be Mexican-source income.[106] Assuming that more than fifty percent of the employees' total income in the calendar year will be Mexican source income because they will travel in Mexico extensively to provide services, domestic law would tend to attribute Mexican tax residence to them.

DTTs concluded by Mexico include a tax-residence tiebreaker rule based on the place where an individual's permanent home is established. Employees usually would be considered nonresidents for Mexican tax purposes by having their permanent home located in the other country under the tiebreaker provisions.[107]

Under a scenario where the employees are traveling constantly from their countries to Mexico, stay a couple of days at a hotel room and then go back, there would be arguments to demonstrate that the employees retained their permanent home in their own countries. If employees stay in Mexico for longer periods of time (e.g., years), thereby leasing or even purchasing a home in Mexico, it is possible that the authorities would assert that they have a permanent home both in Mexico and in the other country, and therefore their country of tax residence will depend on where their "center of vital interests" remains located.

### 2. Taxation of Employees

#### (a) General Rule

Taxation of the employees in Mexico will depend on whether they remain tax residents in their countries or become Mexican tax residents.

#### (b) Mexican Tax Resident Individuals

If employees become Mexican tax residents, they will be taxed on their worldwide income with the result that they will not only be obliged just to pay taxes in Mexico at a progressive rate of up to thirty percent on the salaries received from the employer, but also on any other income they receive, regardless of the place where they receive it.[108]

#### (c) Non-Mexican Tax Resident Individuals

If employees remain non-Mexican tax residents, taxation in Mexico will depend on whether they are employed by a Mexican tax resident (e.g., the SPV) or by a foreign tax resident (e.g., Highways, Inc., its subsidiaries or affiliates) and on whether they stay in Mexico for more than one hundred eighty-three calendar days (whether consecutive or not) within any twelve-month period (including not only days worked at the facility, but also days of presence within the national territory of Mexico, and also fraction of days) ("required calendar days").

***No taxation at source.*** If they are employed by a foreign tax resident and stay in Mexico for fewer than the required calendar days, the employees will not be taxed in Mexico on their Mexican source salaries, both under Mexican law and DTTs.[109]

***Taxation at source.*** Conversely, if employed by a Mexican tax resident (regardless of the time of stay in Mexico) or by a foreign tax resident having stayed in Mexico the required number of calendar days, employees would be taxed on their Mexican source salaries (i.e., those salaries that correspond to services rendered in Mexico), both under Mexican law and DTTs.[110] The law provides the following progressive schedule:

- Non-resident individuals with income of up to $125,900.00 Pesos (approximately US$10,500.00), received during the tax year, are exempt from income tax;
- If the income exceeds the above amount but is less than $1,000,000.00 Pesos (approximately US$83,330.00), received during the tax year, such income would be taxed at a fifteen percent rate;
- Income in excess of $1,000,000.00 Pesos would be taxable at a thirty percent rate.

The actual obligation to pay income tax arises if and when the non-resident employee has completed one hundred eighty-three days of work or presence in Mexico in the last twelve months. The first withholding is made on the basis of all salaries earned from day one to the month when the one hundred eighty-three day period is completed. Thereafter, the withholding is based on each month's payment if the employee has worked or has been present for one hundred eighty-three or more days during the twelve-month period ending on each such month.

Payment should be made no later than the seventeenth day of the month immediately following the salary payments. Payments made after the seventeenth day are subject to interest.

## Endnotes

1. *See* National Infrastructure Program 2007-2012, available at http://www.infraestructura.gob.mx/index9ef4.html?page=english-version (last visited 10 Jan. 2012).
2. "PPS" stands for the Spanish term *Proyectos para la Prestación de Servicios* or Projects for the Rendering of Services.
3. *See* M. Barquín, M. & F. Treviño, La Infraestructura Pública en México (Regulación y Financiamiento) (1st ed. Mexico, 2010) at 280-82. *See also* Asociaciones Público-Privadas para el Desarrollo Carretero de México 2006 (Ministry of Communication & Transp.) at 85–107 (hereinafter, "Infraestructura en Mexico").
4. Infraestructura en Mexico, note 3 *supra,* at 17-54.
5. L.I.E. (Foreign Inv. Law) arts. 17 and 17-A; Gen. Comm. Entities Law arts. 250 and 251.
6. Roads, Bridges, and Fed. Transp. Law art. 6.
7. Income Tax Law art. 2; U.S.-Mexico DTT art. 5.
8. Roads, Bridges, and Fed. Transp. Law arts. 13 and 14.
9. Infraestructura en Mexico, note 3 *supra,* at 27-28.
10. Gen. Com. Entities Law art. 1.
11. Infraestructura en Mexico, note 3 *supra,* at 27.
12. Foreign Inv. Law arts. 4-9.
13. Gen. Com. Entities Law arts. 89, § I and 229, § IV. In practice, a nominal shareholder or partner that could be another subsidiary within the group holds a minimum participation in the corporate capital of the relevant legal entity.
14. Infraestructura en Mexico, note 3 *supra,* at 27.
15. *Id.* at 28.
16. Mexico's current DTT network is as follows: (1) Australia, (2) Austria, (3) Barbados, (4) Belgium, (5) Brazil, (6) Canada, (7) Chile, (8) China, (9) Czech Republic, (10) Denmark, (11) Ecuador, (12) Finland, (13) France, (14) Germany, (15) Great Britain, (16) Greece, (17) Holland, (18) Hungary, (19) Iceland, (20) India, (21) Indonesia, (22) Ireland, (23) Israel, (24) Italy, (25) Japan, (26) Korea, (27) Luxembourg, (28) New Zealand, (29) Norway, (30) Panama, (31) Poland, (32) Portugal, (33) Romania, (34) Russia, (35) Singapore, (36) Slovak Republic, (37) South Africa, (38) Spain, (39) Sweden, (40) Switzerland, (41) U.S., and (42) Uruguay. Information based on the list of DTTs published by the Tax Administration Service on its webpage (www.sat.gob.mx) and updated to January 2012.
17. Income Tax Law art. 183; U.S.-Mexico DTT arts. 7 and 14.
18. Income Tax Law art. 190.
19. There are elements to argue under Mexican law that a concession of a highway qualifies as personal property. *See* Fed. Civ. Code arts. 750, 754, and 759.
20. Income Tax Law arts. 10, 11, 88, and 193.
21. Income Tax Law art. 195.
22. Article 21, Section I, number 2, of the Revenue Law for 2012. In prior years, a transitory provision has been consistently enacted yearly as a temporary income tax provision to be enforceable in the relevant fiscal year. This provision is expected to continue in force on a going forward basis.
23. Income Tax Law art. 195(V). If the foreign financial institution is a tax resident of a tax treaty partner and it is not registered with the Foreign Bank Registry, it could be interpreted that the benefit of a reduced ten percent rate (usually foreseen under the DTTs entered into by Mexico) would not be available in regard to the withholding, but that instead a thirty percent rate would be withheld by the Mexican tax resident payer and the foreign financial institution would subsequently be entitled to request a refund of the difference.
24. *Id.* art. 195, (I)(a)(2).
25. *Id.* art. 195, § V.
26. VAT Law art. 24, § V; VAT Law Reg. arts. 48 and 50.
27. Article 11 of the DTTs entered into by Mexico and its tax treaty partner. Typically, DTTs entered into by Mexico provide for a fifteen percent withholding rate, but there are some DTTs that provide for a ten percent withholding rate (e.g., Luxembourg-Mexico DTT).
28. Income Tax Law art. 195, § V.
29. Treas. Reg. Rule I.3.17.15.
30. VAT Law art. 24, § V; VAT Law Reg. arts. 48 and 50.
31. The flat tax is discussed in Section V.C.1 *infra.*
32. Income Tax Law art. 17; Flat Tax Law arts. 2; 3, § II.
33. VAT Law art. 15, § X(b).
34. *Id.* arts. 14, § I, 18.
35. S.R.L.s cannot issue bonds and place them in the public market.
36. The documents setting forth the financial operation are recorded in the Special Section *(Sección Especial)* of the National Registry of Securities *(Registro Nacional de Valores)* maintained by the National Commission of Banking and Securities *(Comisión Nacional Bancaria y de Valores);* and the information requirements established in the general rules issued for this purpose by the Tax Administration

Service should be complied with (e.g., information regarding the placement of the instruments).

37. Income Tax Law art. 195, § II(a).
38. *Id.* art. 195,¶¶ 12, 13.
39. VAT Law art. 15, § X(i).
40. This requisite applies only if the SPV pays interest to a related party (e.g., Highways, Inc.). Failure to comply would lead to a recharacterization of the interest payment as a dividend. Income Tax Law arts. 31, § (XIV); 86, §§ XII and XV; and 92, § II.
41. This requisite applies only if the SPV received loans from a related party (e.g., Highways, Inc.) and failure to comply with it would deny deduction of interest paid to related parties. However, all interest-generating debt (whether granted by related or unrelated parties) must be considered in calculating the three-to-one ratio. The ratio can be increased if an advanced pricing agreement is obtained and it is demonstrated that a higher leverage ratio is needed due to the taxpayer's particular activities. Income Tax Law art. 32, § XXVI.
42. Income Tax Law art. 31, § V.
43. These requisites apply only if the SPV received loans from non-Mexican tax residents. *Id.* arts. 31, § XIX; and 86, §§ VII and IX(a).
44. Flat Tax Law art. 3, § I.
45. Preoperative expenses are those incurred in research and development related to the design, elaboration, improvement, package or distribution of products or services to be rendered, incurred before taxpayers receive income for the first time. Income Tax Law arts. 38; and 39, § II.
46. VAT Law art. 5, § II.
47. Promexico is a trust created by the Federal Government in June 2007 for purposes of coordinating strategies aimed at strengthening Mexico's participation in the international economy and actions aimed at the attraction of foreign investment.
48. Guidelines for the Granting of Financial Support to Strategic Projects for the Attraction of Foreign Investment.
49. *See* Rules of Operation of Fonadin, available at http://www.fonadin.gob.mx/work/sites/fni/resources/LocalContent/559/10/Reglas_de_Operacion_2011_09.pdf (last visited 10 Jan. 2012).
50. Income Tax Law arts. 10 and 16.
51. Labor Law art. 126, § I.
52. Income Tax Law art. 32, § XXVI.
53. *Id.* art. 39, § IV.
54. *Id.* art. 31, § I.
55. Income Tax Law art. 19.
56. Income Tax Law art. 36.
57. Treas. Reg. Rule I.3.3.2.4, first paragraph.
58. Income Tax Law art. 40, § I.
59. Treas. Reg. Annex 2, Table 1.
60. Income Tax Law art. 220, § I.
61. Treas. Reg. Annex 2, Table 2.
62. *Id.* Rule I.3.3.2.4, second paragraph.
63. *Id.* Rules I.3.3.2.5 and I.3.4.1.
64. *Id.* Rule 1.3.3.2.4, fifth paragraph.
65. Income Tax Law arts. 220, 221 and 221-A.
66. Exceptions to the rule are as follows: (i) interest paid as part of the price of a good upon its purchase directly from the vendor; and (ii) interest paid by financial institutions, because they are generally taxed on the intermediation margin (i.e., they are taxed on the interest earned and are allowed to deduct the interest paid).
67. Royalties are those paid for the temporal use or enjoyment of certain intangible goods (e.g., patents, commercial names, trademarks, etc.). The tax authority has also interpreted that royalties paid in connection with the transfer of technology (know-how) are not deductible when paid to related parties. Royalties do not include, however, payments in consideration of the temporal use or enjoyment of industrial, commercial, or scientific equipment.
68. Salary payments include any payment made by the employer to the employee as consideration for the subordinated services rendered by the employee.
69. Flat Tax Law art. 5 § I; and II.
70. Flat Tax Law art. 10.
71. *Id.*
72. For example, (1) unrendered services paid in advance by the taxpayer to a nonresident service provider would be deductible on a cash basis for flat tax purposes while they would only be deductible for income tax purposes as the services are consumed; and (2) fixed assets would be deductible on a cash basis for flat tax purposes while they would be depreciated over time for income tax purposes. The timing difference between income and flat taxes in these cases would not lead to undesirable consequences, provided that, while there is taxable basis for income tax purposes, there are also NOLs for flat tax purposes that can be carried forward as a tax credit over the following ten fiscal years. Note, however, that in example (2), where the fixed assets are sold before they had been depreciated for income tax purposes and once the NOLs have been lost (after the ten fiscal year carryforward period), the sale could be burdened by a flat tax if the cost basis for income tax purposes is very high, since there would be no cost basis for flat tax purposes.
73. Cash Deposits Tax Law arts. 1, 3, 4, 7 to 9. The cash deposits tax applies to deposits made in Mexican pesos or in foreign currencies in any type of account opened with institutions of the financial system. It is withheld by the institutions of the Mexican financial system (banks, stock exchanges, investment companies, etc.). These institutions must provide taxpayers with monthly and annual certificates of the tax withheld. Note that the cash deposits tax is creditable against income tax (including income tax withheld) and the remainder can generally be compensated against other federal taxes. If after applying the credit and compensation a remainder still exists, the taxpayer can request a refund. The cash deposits tax is not an additional tax burden, but it does have an impact from a cash-flow perspective.
74. Income Tax Law arts. 37, 40 and 42; Flat Tax Law arts. 5, § I; and 6, § I; and III.
75. VAT Law art. 24, § I; Customs Law arts. 95, 96.
76. VAT Law art. 4.
77. Income Tax Law art. 215.
78. Tax Code art. 15-B; U.S.-Mexico DTT art. 12.
79. Income Tax Law art. 200; U.S.-Mexico DTT art. 12.
80. Income Tax Law art. 31; Flat Tax Law art. Article 3, § I.
81. VAT Law art. 20, § IV.
82. Income Tax Law art. 2; U.S.-Mexico DTT art. 5(3).
83. Income Tax Law art. 215.
84. *Id.* art. 4.
85. U.S.-Mexico DTT art. 5.
86. Income Tax Law arts. 180 and 183.
87. Fed. Tax Code art. 15-B, fourth paragraph.
88. Fed. Tax Code art. 15-B, first paragraph.
89. Income Tax Law art. 183. The rendering of services occurs in Mexico when the service provider is physically present at such rendering.

90. Two or more persons shall be deemed related parties when one participates directly or indirectly in the administration, control or capital stock of the other(s); and when another person or group of persons participates directly or indirectly in the administration, control, or capital stock of both persons. Income Tax Law art. 215.
91. *Id.* art. 200.
92. U.S.-Mexico DTT arts. 7, 14.
93. VAT Law art. 24, § V; VAT Reg. art. 48.
94. VAT Law art. 24, § III; VAT Reg. art. 48.
95. VAT Reg. art. 50.
96. VAT Law art. 5, § I.
97. Income Tax Law art. 31, § I. The term of art "strictly essential" has no definition under Mexican law, but several precedents (although not constituting jurisprudence) have been issued by the courts generally providing that expenses are "strictly essential" if they are necessary for the taxpayer to perform its activities and omitting them could lead to a decrease in the taxpayer's productivity. In other words, the payment of these expenses does not appear pointless or superfluous.
98. Income Tax Law art. 31, § XI.
99. *Id.* art. 31, §§ I and XI; Flat Tax Law art. 3, § I; Treas. Reg., Annex 3, 01/Flat Tax.
100. Income Tax Law art. 31, § V.
101. *Id.* arts. 31, § XIX; and 86, § IX(a).
102. *Id.* art. 31, § XI.
103. *Id.* art. 215.
104. *Id.*
105. *Id.* art. 86, §§ XII and XIII.
106. *Id.* art. 9, § I.
107. *E.g.*, U.S.-Mexico DTT art. 4.
108. Income Tax Law tit. IV.
109. *Id.* art. 181; U.S.-Mexico DTT art. 15(2).
110. Income Tax Law art. 180; U.S.-Mexico DTT art. 15(1).

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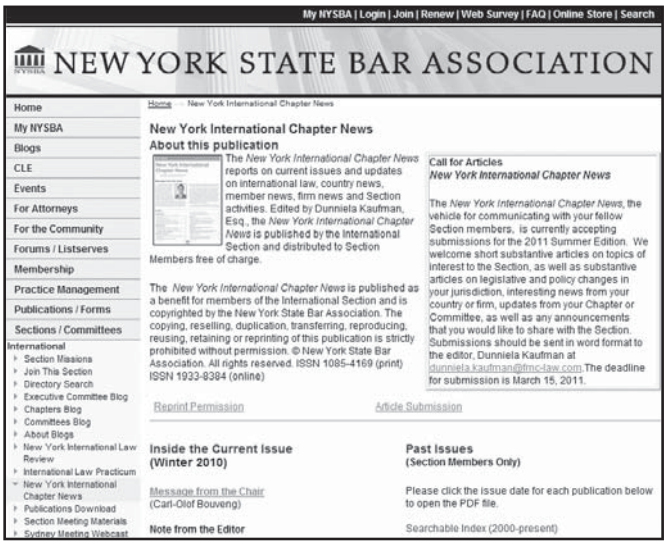


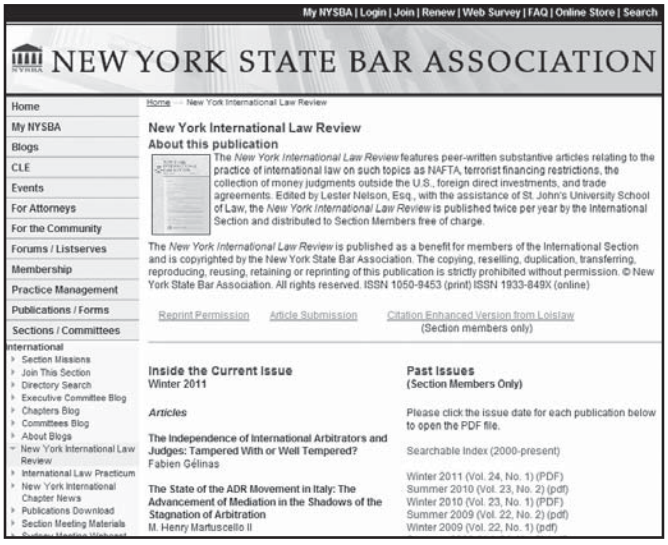


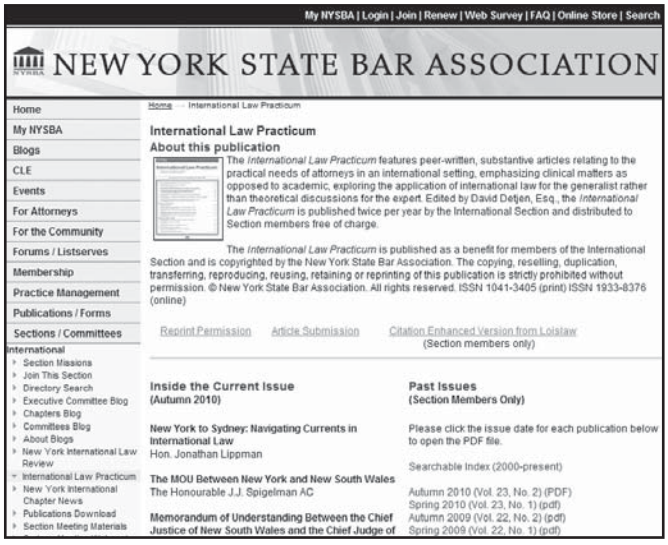


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