STEP BAHAMAS

BAHAMAS
24 JUNE, 2003

PRIVATE BANKING OPPORTUNITIES IN LATIN AMERICA

RICHARD J. HAY

Stikeman Elliott LLP
Dauntsey House, 4B Fredericks Place, London EC2R 8AB
Telephone: +44 (0) 20 7367 0150 Fax: +44 (0) 02 7367 0160

PRIVATE BANKING OPPORTUNITIES IN LATIN AMERICAN

TABLE OF CONTENTS

INTERNATIONAL ESTATE PLANNING FOR LATIN AMERICAN CLIENTS

Richard J. Hay*

Latin American jurisdictions are experiencing significant dynamism in their local political and economic environments. Such instability increases client appetite for geographic asset diversification and so fuels the demand for offshore private banking services.

Tax regimes in Latin America are also evolving rapidly as governments in the region respond to pressures to upgrade their tax systems. International private banks are following these changes closely in order to provide their clients with the increasingly sophisticated structuring required to pursue the attractive opportunities in the region.

This article provides an overview of the major drivers of change, including a review of the impact of worldwide taxation on structuring for offshore investments maintained by wealthy families resident in Mexico, Venezuela, Argentina and Brazil. Implications and strategies for the international banks providing services to private clients in the region are also reviewed. Finally, lessons from the experience in the region are considered for their impact on the strategy for institutions with global private banking businesses.

1. LOCAL PRIVATE BANKING ENVIRONMENT

Latin America is a heavy net importer of both private and public capital. Government attitudes toward foreign investment in the region have, accordingly, necessarily become more benign over the last decade. This has meant that many of Latin America's family businesses have been sold to international and corporate investors, generating vast pools of liquid wealth. Tax systems in the region are, in general, not effectively redistributive so that wealth is very unequally held. For better or worse,

* Richard Hay is the international tax partner in the London office of Stikeman Elliott, Canadian and International lawyers. He is admitted to practice in Ontario, New York and England. Prior to entering practice Mr. Hay was Law Clerk to the Chief Justice at the Supreme Court of Ontario and an Assistant Professor and Lecturer on the Law Faculties at *The National University of Singapore* and the *University of Ottawa* in Canada. The author acknowledges valuable assistance from Robert Reymond, a tax lawyer practising in the London office of Stikeman Elliott.

these and other factors mean that Latin America has many substantial private banking clients.

American and European financial institutions, particularly the New York and Swiss banks, have been active in servicing the needs of Latin American private clients for decades. Families in the region have used these services to export wealth to mitigate perceived local country political risk and enhance personal security by making wealth less visible. Private bankers have provided investment management services for these funds, which were traditionally held either directly or in simple structures such as an offshore company. Occasionally a revocable trust held the company to facilitate personal estate planning or political risk mitigation objectives.

Latin American tax systems historically had a territorial focus, so that tax was imposed only where the income arose from a domestic source. In a strict territorial system, common in the region before the gradual introduction of worldwide taxation in the 1990's, tax is not imposed even on remitted income or gains from a foreign source. Consequently no planning was required in the past to facilitate tax-free accumulation for funds, other than moving the situs of the assets offshore. This situation has now changed.

This paper considers the political and economic drivers for the changes. The changes are summarised at a technical level and some avenues for planning in response are noted.

The following table provides an indication of the relative size of the various national markets which are the subject of this paper, including the US statistics for comparison:

Comparative Economic Data for 2003 (forecast)[1]

	Mexico	**Venezuela**	**Argentina**	**Brazil**	**US**
Population (mn)	103.7	25.66	38.45	172.6	281.8
Total GDP (US$ bn)	679.5	91.47	79.73	423.0	10,188.5
GDP per head (US$)	6551	3564	2073	2450.2	36,155
Annual Inflation (%)	4.1	30.0	30.6	7.7	3.4
Total External debt (US$ bn)	161.00	37.0	195.0	228.0	n/a
Total Ext. debt as % of GDP	23.7	40.4	244.6	53.9	n/a

[1] Source: Mexico, Venezuela, Argentina and Brazil statistics – Latin America Monitor, Business Monitor International (Venezuela, Argentina and Mexico figures are estimates). United States statistics – www.economist.com (please note the US statistics are for the year 2000).

2. BACKGROUND FOR RECENT DEVELOPMENTS

Role of the International Monetary Fund

Yawning public sector deficits have necessitated heavy reliance by Latin American governments on funding from multilateral agencies, particularly the International Monetary Fund (IMF). Such funding comes at a price. Understanding of such intervention is crucial to place recent, and likely future, developments in context.

When entering into credit facilities, the IMF requires a commitment by a jurisdiction to improve its economy by, for example, enhancing the banking system, lowering inflation rates and reducing budget deficits by broadening the jurisdiction's tax base, improving tax collection and reducing expenditures. The credit facilities usually include periodic reviews of the commitments agreed by the jurisdiction to ensure that it is meeting its targets. For example, the recent weakening of the Brazilian economy resulted in the IMF providing it with a US$30 billion credit facility conditional on current and future governments maintaining inflation and fiscal targets.

The IMF and other supranational organisations closely monitor the region's fiscal systems. The IMF follows this scrutiny with considerable pressure on Latin American governments to rectify perceived deficiencies in the design of tax systems and enforcement efforts. A major study by the OECD, for example, concluded that Mexico's 15% level of tax revenues relative to gross domestic product is the lowest among OECD countries.[2] (The next lowest, Turkey, has a 25% rate). The report also notes that personal income in Mexico is considerably lower and more unequally distributed than in any other OECD country, except Turkey. Although the report notes an "environment of non-compliance" it lauds Mexico for an increasingly organised tax bureaucracy, resulting in dramatically improved enforcement of tax laws. The report notes, in particular, that the number of taxpayer audits has increased dramatically and is now on a par with some Western European nations.

Other Latin American countries are subject to similar scrutiny which, as a practical matter, translates into agreed targets for public sector deficits as a condition of renewing IMF funding facilities. These agreements put

[2] Thomas Dalsgaard, "The Tax System in Mexico: A Need for Strengthening the Revenue-Raising Capacity", the Organisation for Economic Co-operation and Development, Economics Department at p.8.

pressure on the governments to review the efficacy of fiscal systems, both as respects design and enforcement.

Domestic Political Developments

Domestic political and economic developments have resulted in rapid evolution in local fiscal regimes. Some of the more significant macro economic and political issues are reviewed here to provide some context for the discussion which follows.

Venezuela has a (apparently formerly) populist leader, Hugo Chavez. Mr Chavez is a former army officer who seized power briefly in 1992 and was returned by the ballot box in December 1998. Mounting concern with his confrontational government style led to a military coup removing President Chavez on April 11th, 2002 followed by a counter-coup restoring the presidency on April 14th.

Venezuelan politics are polarised, with pro and anti Chavez factions now engaged in violent and potentially explosive confrontations. Chavez has recently withstood a protracted general strike threatening oil production in particular. Leadership change will be a messy process played out in an institutional vacuum, given the absence of independent judicial and legislative institutions.

Argentina's decision to unpeg the peso from the US dollar in late 2001 led to an implosion of the country's economy and a significant loss of confidence in the local banking sector. The country now has a 23% unemployment rate without any form of unemployment insurance. GDP is contracted sharply in 2002. Local banks were exposed to huge losses because of the asymmetric "pesification" of dollar deposits and loans (banks must pay ARS 1.40 for every dollar deposited, but can recover only ARS 1.00 for every dollar lent). Over the last 15 months the peso has deteriorated from 1:1 against the US dollar to 3.5 pesos to the US dollar.

Argentina is a federal country with weakening central leadership. Curbing overspending by the provinces has proved to be particularly difficult. Faced with a threat from Roberto Lavagna, Argentina's Economy Minister, that the country may default on debt to the IMF and World Bank, the IMF reluctantly approved a US$6.6 billion loan to cover repayments of past debts due to the Fund itself over the next seven months. This was perceived as a victory for Lavagna's hardball tactics, but the IMF will now be watching closely to ensure adherence to the conditions under which the finance was agreed. Current President Eduardo Duhalde, and whoever wins an election to replace him due in April, will face three main issues: restraining pressures for public spending, cleaning up the country's banks and reigning in maverick judges.

In Mexico, President Vincente Fox displayed a keen sense of the grass roots mood at the time of his election in July, 2000 which marked the end of over 70 years of rule by a single party. He has been far less adept in managing the opposition-controlled Congress. Tension between the President and Congress has frustrated Fox in achieving his agenda, which (under OECD pressure) includes proposals for widespread tax reform. Midterm congressional elections are scheduled for July 2003. If the ruling Partido de Accion Nacional (PAN) succeeds in winning a majority of the seats (not certain at this stage) one would expect a significant change in the pace of Fox's reform agenda.

President Fox proposed the introduction of new rules in late 2001 to enhance the taxation of foreign income owned by Mexican individuals. It was proposed that foreign structures established in (non-listed) high tax jurisdictions which are not taxed at a minimum rate (80% of the Mexican rate or an absolute rate of 15%) should be treated as structures established in prescribed low tax jurisdictions and hence taxable on a current basis. Friction between the President and Congress meant that these proposals were removed from the tax package at a late stage. However, there is little doubt that the Government remains committed, in principle, to the proposed changes and such or similar proposals would be reintroduced if Fox gains control of Congress.

Brazilian politics have been dominated by the presidential elections in the Autumn of 2002. Luis Inacio da Silva, a former left wing radical who has moved strongly towards the centre ground, was elected, and he took office in January 2003.

Lula favours an overhaul of Brazil's convoluted tax system which permits imposition of a patchwork of overlapping taxes at a variety of government levels. Significant change in the fiscal environment is likely in 2003, resulting in aggressive expansion of the taxation of the country's wealthier residents (i.e. private banking clients).

Tax Treaty Pressures

Countries with worldwide tax systems, including the US, have been reluctant to enter into double taxation treaties with Latin American countries with territorial tax systems. For example, the US had negotiated and signed a tax treaty with Brazil and Argentina; however, it was unwilling to bring either treaty into force.[3] This has placed pressure on Latin jurisdictions to reform their tax systems to encourage high tax jurisdictions to enter into tax treaties in order to facilitate essential inbound foreign investment. Tax treaties would also encourage foreign investment as they provide some tax certainty in a dynamic environment.

The US waited to enter into a tax treaty with Venezuela until Venezuela had adopted legislation concerning a worldwide system. Thus, the US/Venezuela tax treaty had been under negotiation for many years but entered into force on January 1, 2000, two months after Venezuela adopted proposals to move to worldwide taxation.

3. The Move to Worldwide Taxation

As a result of all of these pressures, Latin American tax systems are evolving rapidly to significantly increase revenue from direct taxation. The most significant change in system design relates to adoption of rules to implement effective worldwide taxation for local residents. Latin countries have also adopted anti-avoidance and anti-deferral measures to support new tax regimes, including controlled foreign company (CFC) legislation, transfer pricing regulations and thin capitalisation rules.

CFC regimes normally provide for some level of control to be exercised by the shareholder over the foreign corporation before the rules will apply. For example, Spanish rules require that an individual or corporation resident in the country must generally own directly or indirectly or through related parties, 50% or more of a foreign corporation's capital, equity, voting rights or profits before CFC exposures apply.[4]

An additional issue is the type of foreign entity to which the rules apply. The legislation in certain jurisdictions, including Spain and the United Kingdom, generally applies only to foreign corporations whereas the new

---

3 Joseph H. Guttentag "An Overview of International Tax Issues" *University of Miami Law Review* April 1996 Vol. 50 No. 3 at p.451. The only Latin American countries with which the US currently has a treaty are Mexico and Venezuela.

4 Pedro Amata and Pablo Monasterio, "Controlled Foreign Corporation Legislation", *Bulletin for International Fiscal Documentation* 1995 Vol. 40 No. 6 at p.289.

rules in Mexico and Venezuela apply to all forms of foreign entities (including companies, partnerships and trusts).

These issues have produced many different models of CFC legislation which, in certain cases, differ fundamentally from one country to the next. However, the result of the CFC rules is usually the same in every jurisdiction: income from the foreign entity will be attributed to the domestic taxpayer and subject to tax on a current basis.

Latin policy makers had a variety of design choices to achieve their objectives. The emerging pattern in the region is adoption of a model with a prescribed blacklist for low tax jurisdictions similar to the model deployed by Spain. The Spanish CFC rules apply where the effective tax rate in the foreign country is less than 75% of the effective Spanish rate on the same income.[5] Countries on the Spanish prescribed blacklist are deemed to satisfy this requirement. The first Latin country to adopt the blacklist route was Mexico, closely followed by Venezuela and Argentina, with Brazil expected to adopt rules applicable to individuals soon.

These changes require a dramatically increased sophistication in the structures which private bankers must discuss with clients, for the simple reason that *existing structures to hold offshore assets become immediately reportable and taxable* on adoption of the new CFC rules. A discussion of these developments and a review of the technical changes, country by country, is set out below.

4. Recent Technical Changes to Rules in Mexico, Venezuela, Argentina and Brazil

Latin American governments commenced adoption of worldwide tax regimes in the early 1990's. Such systems are invariably extremely complex, so they take time to develop and implement. Argentina, for example, adopted worldwide taxation in 1992, but delayed adopting supporting regulations until 1998. Mexico adopted worldwide tax in 1994 and Brazil adopted worldwide tax for corporations in 1996, having already moved towards worldwide tax for individuals.

In most cases these early steps were not accompanied by companion rules providing for taxation of controlled foreign companies, so the provisions for worldwide taxation were largely toothless. Thus, worldwide tax was

5 Gabriel Pretus, "The Spanish Tax Havens' "Black List" a Treasury of Anti Avoidance Rules", ITPA March 31 1999.

easily avoided by the interposition of a foreign tax haven company which facilitated deferral as long as the profits were not distributed. Outright avoidance was also possible, to the extent that profits were spent by the company rather than distributed to the shareholder.

The main development, accordingly, has been the recent adoption of CFC type rules for foreign companies established or controlled in prescribed low tax jurisdictions, which makes provisions for worldwide taxation practically effective. CFC rules have now been adopted in Mexico, Venezuela, Argentina and Brazil. Brazilian CFC rules are not yet applicable to individuals (they are limited to corporations) but they are expected to become so soon.

Mexico

The government of Mexico makes tax changes annually, normally in the autumn, with effect from the following calendar year. Mexico adopted CFC rules in late 1996, with effect from January 1, 1997. Initially, the regime technically applied where a Mexican resident held an interest in a low tax jurisdiction investment, even where the Mexican did not control the investment. This unfair result was remedied as of January 1, 1998 when the requirement that a Mexican control a low tax jurisdiction investment was included in the rules. In 1999, the Mexican government broadened the meaning of resident to include a foreign corporation that has its principal administration or place of effective management in Mexico.[6]

Mexico's CFC rules generally provide that income which arises in an investment or entity (first and lower tier) located in a prescribed territory with a preferential tax regime (TPTR)[7] will accrue into the income of a Mexican resident and be taxed on a current basis where the Mexican resident exercises control, directly or indirectly, over the investment or entity in a TPTR. For these purposes control is presumed subject to the taxpayer rebutting the presumption.

The following investments are deemed to be located in a TPTR:

(i) an account or investment in a financial institution located in a TPTR;

---

[6] Article 9(II) of the Federal Fiscal Code; see also 1999 Reform Decree, Article 1 and the 2000 Fiscal Miscellaneous Resolution.

[7] Mexico has released a comprehensive list of countries which are considered to be TPTRs (prior to 2002 these were referred to as law tax jurisdictions). The current list is attached in Appendix A.

(ii) where the entity has a physical presence in, or a P.O. Box in, a TPTR;

(iii) where the entity has a domicile in a TPTR;

(iv) where the entity is created under the laws of, or is regulated under the laws of, a TPTR; or

(v) where the entity's place of effective or principal management is in a TPTR.

A Mexican resident has reporting requirements in February of each year in respect of directly or indirectly controlled investments in a TPTR which obtain income. In addition, expenses incurred by the entity in a TPTR will not be deductible by the Mexican resident unless the accounts of the entity are available for review by the Secretaria de Hacienda y Crédito Publico (Hacienda) and the Mexican resident satisfied his reporting obligations in a timely manner.

There are, however, exceptions pursuant to which an investment is not considered to be an investment in a TPTR. These are as follows:

(i) an investment in a TPTR entity engaged in an active business where 50% or more of the investment represents fixed assets, land or inventory and passive income does not exceed 20% of the total income received by the Mexican resident;

(ii) investments through an entity which is resident in a country that has adopted CFC rules provided those rules effectively apply to the entity;

(iii) investments involving legal entities incorporated in Mexico even where the entity has assets or operates in a TPTR;

(iv) investments by individuals that do not exceed $160,000 in a year; and

(v) investments where a Mexican resident's average indirect participation per day does not permit the Mexican resident to exercise effective control over the investments or over the management of, or the distribution policy of, the entity (as mentioned above, control is rebuttably presumed).

In 2001, President Fox proposed wide-ranging amendments to Mexican tax rules, including changes to CFC rules, though Congress did not approve the changes. The draft rules would have applied to deem a structure to be located in a TPTR where income of the structure was subject to an effective income tax rate that was lower than 80% of the Mexican tax rate. An alternative proposal was to apply the new rules to a structure the income from which was subject to a general tax rate lower than 15%. The draft rules would have significantly broadened the scope of Mexico's CFC rules. The Mexican President remains, apparently, committed to the policy in the new rules and it is likely that he will re-submit similar rules to Congress later this year.

The transitory rules to the 2003 Mexican tax reform provided that a TPTR may be removed from the Mexican blacklist if the jurisdiction entering into an exchange of information agreement with Mexico. This could provide opportunities for listed jurisdictions to recapture work lost to high tax jurisdictions since 1997.

Venezuela

Venezuela has historically operated a strict territorial regime, taxing residents only on local source income. Even remitted foreign income was excluded from the tax base.

Rules in a new Income Tax Law[8] effective January 1, 2001, now make Venezuelan residents subject to tax on both domestic and foreign source income.[9] A unilateral tax credit will generally be granted for taxes paid in foreign jurisdictions. Non-residents continue to be subject to tax on Venezuelan source income but pursuant now to expanded rules. In this respect, the ITL has introduced a definition of "permanent establishment" and Venezuelan-source income.

In a related development, a new general anti-avoidance rule was also adopted for tax-driven transactions. Article 95 of the ITL, adopted in October 1999, provides the Integrated National Service of Tax Administration ("SENIAT") with the power to disregard contracts, the incorporation of companies and generally legal forms and procedures where the fundamental intention of such transactions is to evade, elude or

---

8 Official Gazette of the Republic of Venezuela, Issue No. 36.813, October 22, 1999 [hereafter the "ITL"].

9 Pursuant to the worldwide regime, a taxpayer will have two pools of income: (i) Venezuelan source income and (ii) offshore income. A Venezuelan's income will be calculated separately according to these types of income and tax allowances and deductions will also apply to each type of income (see Miguel Valdés, "Venezuelan Tax Reform: Worldwide System of Taxation Adopted", *Practical Latin American Tax Strategies* February 2000 Vol. 3 No. 2 at p.4).

reduce the effect of the application of the ITL. The Organic Tax Code was also recently amended to significantly increase the powers of the Venezuelan tax administration in this respect.

Venezuela has adopted controlled foreign company type legislation in a form similar to the rules adopted in Mexico in 1997. There are, however, a number of important differences, both in the general design of the tax systems and in the detail in the new rules. The changes require reporting of income and impose reporting obligations on Venezuelan residents with a direct or indirect investment located in a low tax jurisdiction (LTJ).[10] These requirements apply where a Venezuelan resident has control over the distributions from, or exercises management and control over, such LTJ investments. The required control is presumed subject to the taxpayer rebutting the presumption (see Article 101 ITL). These rules would generally not apply where over 50% of the total assets of an investment are fixed assets used to carry on an enterprise in a LTJ.

The following investments or entities are deemed to be located in a LTJ:

(i) accounts or investments of any kind in institutions located in a LTJ (when a taxpayer opens such an account for the benefit of a spouse, concubine, ascendant or descendant, the account is deemed to be an investment of the taxpayer);

(ii) entities with a domicile or P.O. box in a LTJ;

(iii) entities with their main administrative headquarters or place of actual or principal management or administrative office or permanent establishment in a LTJ;

(iv) entities with a physical presence in a LTJ;

(v) entities created under the laws of a LTJ; or

(vi) entities whose business is conducted, regulated or formalised under the laws of a LTJ.

Venezuelan residents will be required to file information returns within 3 months after the end of their fiscal (normally calendar) year in respect of direct or indirect controlled investments made or maintained in LTJs in the preceding taxation year.

---

10 On 28 March 2001, SENIAT released a list of LTJs in an administration ruling (published in Official Gazette No. 37.168). The current list is attached in Appendix B.

Pursuant to these rules, Venezuelan residents must include in their income the gross income earned in a controlled LTJ investment. A deduction for expenses incurred at the level of the investment will not be allowed unless the accounting records of the LTJ investment are made available to the SENIAT and the Venezuelan resident files the information return described above.

The Venezuelan tax haven blacklist was revised by new regulations tabled on 15 January 2003. The order provides that jurisdictions with which Venezuela has a double tax treaty which includes provision for information exchange will not be subject to the rules applicable to low tax jurisdictions even if they meet existing criteria (essentially taxing income at a rate of less than 20%). In addition, the following countries have now been deleted from the original list: the Netherlands Antilles, Jamaica, Marrakech, Tonga, Botswana, Cameroon, Ivory Coast, Costa Rica, El Salvador, Guatemala, Guinea, Lithuania, Maldives, Namibia, Nicaragua, South Africa, Zaire, Zimbabwe, Paraguay, Senegal and St Kitts.

Argentina

Argentina adopted CFC rules on December 31, 1999[11], effective for fiscal years beginning as of December 31, 1999. Argentine rules are very brief and give the impression of extreme haste in their design, which is not surprising as they became effective less than a month after the newly elected Alliance government took office. Though the policy objective is similar, Argentina's rules differ significantly from those adopted by Mexico and Venezuela.

Argentina's rules are more limited as they apply solely to directly held corporations created or located in low tax countries or in countries which do not levy a tax. Trusts, partnerships and other types of entities are not made explicitly subject to the CFC regime. However, the Argentine rules are broader than those of Mexico and Venezuela as there is no requirement that an Argentine resident control the LTJ entity.

The new regime only applies to income derived from interest, dividends, royalties, rents or other similar passive taxable income specified in the regulations. Thus, where an Argentine resident holds shares in a corporation created or located in a LTJ, passive income earned by the corporation will be allocated to the Argentine resident on an annual basis, irrespective of whether the Argentine resident controls the LTJ company.

[11] See Article 133(a) of Tax Reform Law No. 25,239.

Decree 290/2000 implements Law 25,239 that was adopted on December 31, 1999. The Decree was effective April 3, 2000 and applies retroactively to the effective date of Law 25,239. Prior to the Decree, there was some uncertainty as to whether Argentina's new CFC rules applied to foreign corporations in any jurisdiction or only to corporations in LTJs. Section 1(q) of the Decree clarifies that the CFC regime will only apply to corporations located in LTJs. A list of LTJs was released in Decree 1037/2000[12], effective from 14 November 2000, and is attached in Appendix C.

Argentina also imposes a tax on personal assets, and so that country differs from Mexico and Venezuela, which have gift and death taxes but not wealth tax. The rate of tax is 0.75% and 1.5% for assets located in Argentine that are held by an LTJ entity. Law 25,585[13], effective as of 31 December 2002, expands this tax to apply, at a rate of 0.5%, to all non-Argentine resident companies that hold equity interests in Argentine companies. Other Argentine sited assets held by LTJ companies continue to be subject to a 1.5% tax. The existence of this tax significantly enlarges the planning needs over those considered in Mexico and Venezuela.

Brazil

Brazilian resident individuals have been subject to tax on their worldwide income since 1939. From January 1, 1996 corporations in Brazil also became subject to a worldwide tax system.[14] The 1996 tax reform also introduced CFC rules applicable to Brazilian corporations.

Initially, Brazil's CFC regime provided that the undistributed income of a controlled[15] or associated[16] foreign company would be attributed to the Brazilian corporate shareholder and taxed annually. This regime was far reaching as there were no exceptions. Furthermore, the regime did not distinguish between income earned in LTJs or high tax jurisdictions.

---

[12] This Decree was published in the Official Gazette on 14 November 2000.

[13] This law was published in the Official Gazette on 15 May 2002.

[14] Law No. 9.249 published in the official Gazette on December 27, 1995.

[15] Generally, control is ownership of more than 50% voting shares. However, the Brazilian company must control the foreign company's policy and elect directors or managers. Therefore, it is possible that a holding of less than 50% would result in the required control.

[16] Generally, a Brazilian company is associated with a foreign company if it holds at least 10% of the foreign company's capital and influences corporate activities. See Teresa C. Mello de Almeida Prado, "Brazil Moves to Worldwide Tax on Corporate Income", *FT World Tax Report* March 1996 Vol. XXI at p.44. and Nélio Weiss and Joseph Wolf, "Brazil's 1999 Tax Year in Review", *Tax Notes International* January 3 2000 at p.19.

Shortly thereafter, however, the Brazilian Federal Revenue narrowed the scope of the CFC regime in Normative Instruction n. 38.[17] Article 2 provided that profits earned abroad would only be included in the income of a Brazilian company when such profits were made available to the Brazilian company. Profits are considered to be made available when paid or credited to a Brazilian company. Thus, the rules no longer attributed income from the CFC to a company in Brazil. In August 2001 the CFC rules were again amended, in favour of a more expansive CFC regime. The new rules provide that income of a CFC is taxable to the Brazilian parent company on 31 December of each year, irrespective of whether the Brazilian parent receives a dividend from its CFC.

There are other anti-deferral regimes in Brazil which apply specifically to entities in LTJs. These include a higher withholding tax on payments of income made to LTJs and, for purposes of Brazil's transfer pricing rules, a taxpayer that transacts with a company in a LTJ is subject to the transfer pricing rules irrespective of whether they are related or not. For the purposes of both these rules, a LTJ includes a country which has no income tax or imposes a tax rate of less than 20%. This may provide some insight as to how Brazil would define a LTJ if it adopted a CFC regime applicable to individuals comparable to those in other Latin countries.

Brazilian individuals are not yet subject to a CFC regime. This will likely change following the adoption of rules pursuant to Complementary Law 104, dated 10 January 2001, which provides the government with broad powers to determine the moment when foreign revenue and income become available, and therefore taxable to Brazilian residents. Accordingly, there are indications that individuals will become subject to a CFC regime in the near future. Rigid constitutional constraints forbidding the taxation of unreceived income mean that any new rules introduced will be subject to considerable litigation.

Individuals are already obliged to provide disclosure concerning worldwide assets in their tax return. The Central Bank of Brazil is now compiling its own list of foreign assets. Brazilians were required to file a list of assets owned abroad by the end of the first quarter, 2002 with the Central Bank.

---

[17] Published on June 28, 1996.

5. Response of the Private Banks to the New Regimes

Historically, structures established by Latin private clients were located in listed LTJs, for the obvious reason that such structures do not attract tax in the host jurisdiction. The new CFC rules in Mexico, Venezuela and Argentina mean that income and gains arising in such LTJ structures is now liable to local tax where the controlling shareholder resides in one of those Latin countries. Structures in blacklist jurisdictions need to be redesigned to avoid reporting obligations and tax exposures.

Most private bankers have become tax-sophisticated in order to develop structures to capture (or retain) the lucrative investment management business sought by the financial institutions. A minority have not done so. Should those bankers simply continue with existing LTJ structures and leave it to the clients to sort out local tax issues?

The UK and US governments, the OECD and the UN have pressed offshore jurisdictions to adopt legislation to criminalise conduct where retention of the proceeds of crime is facilitated by a local financial institution or professional. In some cases the legislation explicitly extends to proceeds of foreign tax evasion. Where such legislation does not currently extend to foreign tax evasion there is a good prospect that it will do so in future.

Many banks have now had painful experiences in attempting to jettison business that looked acceptable at the time it was taken on (i.e., lucrative despite the risks), but which was subsequently perceived as dangerous, limiting to the objectives of another part of the bank, or simply too resource intensive to maintain. Thus, a bank expanding into an onshore location from which poorly evaluated business was accepted in the past is apt to regret past failures to properly price risk in its client portfolio. Banks, particularly American ones, also find it embarrassing to respond to local treasury officials concerned about portfolios filled with tax evading clients.

Highly visible or careful clients will want to restructure at the outset. Less scrupulous clients are likely to be dragged along in due course by country club chatter or visible teeth in government enforcement efforts. Timely restructuring usually confers the additional advantage of easily permitting maintenance of cost basis in the new structure with significant consequent advantages for future distributions on ultimate collapse. For all these reasons, any responsible institution is likely to see it as being in its own, and certainly the client's, best interests to move now to structures compliant with the new rules.

6. Need for Proactive Strategy

Reformatting existing offshore structures requires attention both to local law and international planning opportunities. Most local Latin American professionals experienced in moving money across borders will have been concerned primarily with importing private capital for local investment. In territorial tax systems returns from money invested abroad are simply not taxable, with the result that local professionals have been consulted infrequently where resident clients were exporting or repatriating funds held offshore. In consequence, with a number of notable exceptions, Latin American tax professionals have tradionally had little need to follow international planning structures and opportunities.

The pool of professional talent familiar with both local and international requirements is small, particularly considering the current high demand for help. For international private bankers, this is a fundamentally distinguishing characteristic in the Latin market. In Asia, the market that entranced private bankers over the 1990's, local professional advice on capital export was readily available and since most structures were pre-immigration planning for moves to high tax countries such as Canada, the US and Australia, sophisticated international advice was readily available. In that environment, banks normally took the view that they were largely passive facilitators of structures designed by professionals acting for the client (i.e., they were not responsible for the efficacy of the planning advice).

In the Latin American context, bankers that wait passively for clients to come to them with "fully cooked" plans for offshore structures may wait forever, and find that their existing client base is cannibalised by other institutions in the meantime. The structures are complex and there simply is not enough experienced professional talent to make one-off structuring practical for the number of clients who need immediate advice in view of the rapid and complex changes in the local environment. In consequence, banks with a serious interest in the region have been active in considering their own tax sensitive structures to respond to local client needs.

7. Designing Compliant Structures For the New Regimes

What considerations need to be taken into account in the design of such structures? At minimum, foreign structures holding client assets must be designed to mitigate local income, gains, gift, estate and wealth taxes, as well as reporting obligations, all in a compliant fashion. The foreign structure should be constructed so as to avoid similar exposures and reporting obligations in the jurisdiction where it is established, resident or holding assets. Reformatting out of existing arrangements into a new structure should also be conducted in a manner which does not create any such liabilities.

Many private clients are used to exercising control over investments held in their structures. Such arrangements need to be examined for their potential to create local tax exposures under new laws. Where securities are to be held in onshore countries such as the US, care must be taken to ensure that the new structure does not create estate tax liabilities on the death of the local owner, or settlor of a (typically revocable) trust where one is used. The structure should also anticipate the prospect of tax-efficient distributions or ultimate payout on termination, and so should be designed to mitigate local income, gift and estate tax liabilities when funds leave the structure.

Many existing and more new structures will use a trust, normally revocable, in order to facilitate estate planning, tax and confidentiality objectives. Use of trusts in civil law jurisdictions inevitably raises characterisation and possible transparency issues with fiscal consequences.

Most new structures will also include an onshore company, or possibly a hybrid (between partnership and corporate status) or possibly a straight partnership. Such structures need to be established and run outside a prescribed LTJ, but ideally will not attract tax or reporting obligations in the high tax jurisdiction where they are established and managed.

The point of the LTJ lists adopted by national Latin governments is to preclude the use of foreign tax-free structures. Most onshore structures (i.e., those in countries not on the prescribed list) are, of course, taxable. Irish non-resident companies were widely used as an immediate response to the Mexican changes, but virtually all were unwound by September 1999 when the Irish government established that date as the deadline after which such companies would no longer be insulated from local Irish tax. Popular substitutes involved use of companies in high tax jurisdictions that were not taxable for one reason or another or structures which were tax transparent (and so not taxable) where established but recognised as separate legal entities under the law of the relevant Latin American jurisdiction.

Traditional onshore corporate entities have the considerable advantage of being conventional and therefore readily comprehensible to clients and the bankers who operate them. However, such structures are often established under relatively arcane general law (i.e., nothing like the operating flexibility of a modern offshore international business corporation statute). Winding up such structures on termination is also complex and costly. Striking off is a possibility on ultimate termination, though that procedure leaves "long tail" liability for directors.

Local corporate law often requires public filings disclosing directors, officers, shareholders and full or abridged financial statements. Such filings are accessible to any member of the public for payment of a nominal fee. Information on structures established in treaty jurisdictions may also be available through exchange mechanisms provided by bilateral tax treaties.

An alternate possibility is the use of corporate hybrid such as a US LLC. These appear attractive planning vehicles on initial consideration as they can be structured to avoid US taxes and the US is not a prescribed LTJ. However, Latin clients often have reservations about the risk that such structures may lead to US exposures and possible information exchange with Latin tax authorities.

Tax transparent structures located in high tax jurisdictions (such as certain partnerships) have also been deployed as investment vehicles for Latin families. These are contractual, so that the constitution and operation of such structures is not subject to the detailed regulation invariably applicable to companies. The consequent flexibility in design of these vehicles facilitates the complex arbitrage of the tax requirements of the various jurisdictions involved in the structure. Information available on partnerships is generally more limited than that available on corporate registers. In some circumstances even local registration may not be required with the perceived advantage that no information at all may be available to local authorities. Contractual vehicles are also cost efficient to maintain and easy to wind-up on termination.

8. NEW PRIVATE BANKING OPPORTUNITIES

This section reviews opportunities for private bankers in the Latin American region which have arisen over the past year.

In Mexico the government is, as discussed above, considering significant expansion in the existing rules for taxing foreign income of Mexican residents. In particular the government is concerned, following OECD prompting, about the use of non-listed (i.e. high tax) jurisdictions for establishment of structures that are not liable to tax in the jurisdiction where established. To combat such planning the government considered, at the end of 2001, introduction of new rules which would treat structures as, in effect, established in preferential tax regimes where the structure is not taxed at a minimum of 80% of the Mexican rate or, in a proposal which never became formerly tabled, at an absolute rate of 15%.

A broader based dispute between President Fox and Congress over fiscal reform (centering mainly on VAT on food and medicines) derailed the plan for changes at the last moment, although there is little doubt that changes with similar policy objectives remain under consideration. Private bankers should prepare to respond to such changes, as the consideration of such or similar proposals is likely this year.

Curiously, the limited Mexican tax legislation which was adopted at the end of 2001 removed the existing reporting obligation for structures established in JPTRs where the structure did not have income. Accordingly, a portfolio which can be structured to give rise to no income could be held in a structure established in a JPTR, with no Mexican reporting obligation or tax exposures.

In Argentina clients' concerns have expanded to include political risk. Private bankers should consider, in particular, the use of bilateral investment protection treaties (BITs). BITs are similar to tax treaties, in that they are entered into on a sovereign-to-sovereign basis, and they are designed to protect persons in one signatory state investing in the other signatory state. BITs do not generally contain "limitation of benefits" articles.

BITs typically provide protection for foreign exchange controls, in the form of guarantees for the repatriation of profits, capital gains, dividends and royalties including, generally, provision for such payments at prevailing exchange rates in a freely convertible currency. Argentina has concluded more than 40 of such treaties and clients invested in domestic assets in Argentina (including clients resident in the country) should consider use of such treaties to mitigate political risk.

In the Brazilian context private bankers are finding that while offshore structures are still technically effective to facilitate tax-free accumulation of income and gains for individuals, there is increasing reluctance to use offshore structures established in "traditional" offshore centres. As noted above, Brazil has moved to worldwide taxation of companies, now with a reasonably effective CFC regime. Proposals to extend such taxation to foreign structures controlled by individuals are under active consideration (as noted in the technical section above). Accordingly, bankers are finding a ready client appetite to restructure existing tax haven arrangements to take account of likely future developments.

No immediate changes are in prospect for the existing Venezuelan taxation of low tax jurisdiction structures, patterned after current Mexican rules. However, increasing perceptions of instability in the government have increased client appetite for offshore (including political risk) planning and the overall market for private banking services.

9. Future Developments

Domestic tax systems invariably become much more complex once the decision is made to track and tax worldwide income of resident taxpayers. The experience of other countries which have moved to worldwide taxation with complementary CFC rules suggests that years of painstaking effort on the part of tax authorities will be necessary to adjust the system to tax international income in a fair and effective manner.

Mexico was the first Latin American country to adopt a system for worldwide taxation with a complementary controlled foreign company rules. As noted above, Mexico is contemplating new proposals for a "second generation" set of rules to enforce policy goals. If such rules are adopted (which appears possible this year) such rules may well cascade down to other Latin American countries.

External and internal pressures to reduce fiscal deficits will incentivise Latin governments to continue the work now commenced to improve tax compliance and upgrade the international dimension in local tax systems. This augurs an interesting and dynamic period ahead for the private banks, clients and their advisers as all parties seek to adjust and adapt offshore structures to the new regimes now underway.

Appendix A

Mexico

Prescribed List of Territories with Preferential Tax Regimes

In the Americas:
Anguilla; Antigua and Barbuda; Aruba; the Bahamas; Barbados; Belize; Bermuda; the British Virgin Islands; the Cayman Islands; Costa Rica; Dominica; Grenada; Guyana; Honduras; Montserrat; Panama; Puerto Rico; St. Kitts and Nevis; St. Pierre and Miguelon; St. Vincent and the Grenadines; the Netherlands Antilles; Trinidad and Tobago; the Turks and Caicos Islands; Uruguay and the US Virgin Islands;

In Europe:
Albania; Andorra; Azores; Campione d'Italia; Canary Islands' special zone (ZEC); the Channel Islands; Cyprus; the Falkland Islands; Greenland; Gibraltar; the Isle of Man; Liechtenstein; Macau; Madeira; Malta; Monaco; Ostrava Free Zone; San Marino; St. Helena; Trieste and Tristan da Cunha;

In Africa and the Middle East:
Angola; Bahrain; Cape Verde; Djibouti; the United Arab Emirates; Jordan; Kuwait; Liberia; Mauritius; Oman; Qatar; Qeshm Island; the Seychelles; Swaziland; Tunisia and Yemen;

In Asia and the Pacific;
American Samoa; Brunei; Christmas Island; the Cocos or Keeling Islands; Hong Kong; Guam; Norfolk Island; the Cook Islands; Kiribati; Labuan; Maldives; the Marshall Islands; Nauru; Niue; Belau; Pitcairn; French Polynesia; Western Samoa; the Salomon Islands; Svalbard Archipel; Sri Lanka; Tonga; Tokelau; Tuvalu and Vanuatu.

Appendix B

Venezuela

Prescribed List of Low Tax Jurisdictions

Albania
Andorra
Angola
Anguilla
Antigua and Bermuda
Aruba
Ascencion
Bahamas
Bahrain
Belize
Bermuda
British Virgin Islands
Brunei Darussalam
Campione D'Italia
Canary Island's Special Zone (ZEC)
Cape Verde
Cayman Islands
Channel Islands
Christmas Islands
Cook Islands
Cyprus
Djibouti
Dominica
Dominican Republic
Falkland Islands
French Polynesia
Gabon
Gibraltar
Greenland
Grenada
Guam
Guyana
Honduras
Hong Kong
Isle of Man
Jordan
Keeling Islands (Cocos)
Kiribati
Kuwait
Labuan
Lebanon
Liberia

Liechtenstein
Luxembourg
Macau
Malta
Marshall Islands
Mauritius
Monaco
Monserrat

Nauru
Nevis
Niue
Norfolk Island
Oman
Ostrava Free Zone
Pacific Islands
Panama
Patau
Pitcairn Island
Puerto Rico
Qatar
Qeshm Island
Saint Cristabel
Saint Helena
San Marino
Saint Pierre and Miquelon
Saint Vincent and the Grenadines
Salomon Islands
Samoa (American)
Samoa (Occidental)
Seychelles
Sri Lanka
Svalbard Archipelago
Swaziland
Tokelau
Tristan da Cunha
Tunisia
Turks and Caicos Islands
Tuvalu
U.S. Virgin Islands
United Arab Emirates
Uruguay
Vanuatu
Yemen

Appendix C

Argentina

Prescribed List of Low Tax Jurisdictions

Albania
Andorra
Angola
Anguilla
Antigua and Barbuda
Aruba
Ascension
Azores Islands
Bahamas
Bahrain
Barbados
Belize
Bermuda
British Virgin Islands
Brunei Darussalam
Campione D'Italia
Cape Verde
Cayman Islands
Channel Islands
Christmas Island
Cook Islands
Cyprus
Djibouti
Dominica
French Polynesia
Gibraltar
Greenland
Grenada
Guam
Guyana
Hong Kong
Isle of Man
Jordan
Keeling Islands
Kiribati
Kuwait
Labuan
Liberia
Liechtenstein
Luxembourg
Macao
Madeira
Maldives
Malta
Marshall Islands
Mauritius
Monaco
Montserrat
Nauru
Netherlands Antilles
Nevis
Niue
Norfolk Island
Oman
Ostrava
Pacific Islands
Panama
Patau
Pitcairn Island
Puerto Rico
Qatar
Qeshm Isle
Samoa (American)
Samoa (Occidental)
San Cristobal
San Marino
Seychelles
Solomon Islands
Sri Lanka
St. Helena
St. Lucia
St. Pierre and Miquelon
St. Vincent and the Grenadines
Svalbard archipelago
Swaziland
Tokelau Islands
Tonga
Trieste
Trinidad and Tobago
Tristan da Cunha
Tunisia
Turks and Caicos Islands
Tuvalu
U.S. Virgin Islands
United Arab Emirates
Uruguay
Vanuatu
Yemen