



GUATEMALA

TECHNICAL ASSISTANCE REPORT-INTERNATIONAL TAXATION CHALLENGES AND OPTIONS

April 2023

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TECHNICAL ASSISTANCE REPORT

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International Taxation Challenges and
Options

April 2022

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ABBREVIATIONS AND ACRONYMS

BEPS	Base erosion and profit shifting
CbC	Country-by-country report
CDIS	Coordinated Direct Investment Survey
EUR	Euro
FAD	Fiscal Affairs Department
FDI	Foreign direct investment
FHTP	Forum on Harmful Tax Practices
GDP	Gross domestic product
GLoBE	Global Anti-Base Erosion Proposal
IIR	Income inclusion rule
IMF	International Monetary Fund
ISR	Income tax
LOB	Limitation of benefits
MAP	Mutual Agreement Procedure
MLA	Multilateral Agreement
MNE	Multinational enterprise
OECD	Organisation for Economic Co-operation and Development
PPT	Principal purpose test
SAT	Superintendency of Tax Administration
STTR	Subject to tax rule
TADT	Treaty for the avoidance of double taxation
UN	United Nations
UTPR	Undertaxed payments rule

PREFACE

In response to a request by the Ministry of Public Finance (MFP) of Guatemala, a remote technical assistance mission was carried out by the Fiscal Affairs Department (FAD) of the International Monetary Fund (IMF) from March 7 to 21, 2022, to analyze certain international aspects of the country's tax regime. Discussions focused on the policy regarding treaties for the avoidance of double taxation and their effectiveness in attracting foreign direct investment, transfer pricing regulations, and the implications for Guatemala of the minimum standards agreed by the tax base erosion and profit shifting (BEPS) project backed by the G20 and the Organisation for Economic Co-operation and Development (OECD). The mission comprised Roberto Schatan (FAD and head of mission), Carolina Osorio (FAD), and Armando Lara and Jose Madariaga (external advisors).

The mission met with the Vice-Minister of Public Finance, Mr. Saul Figueroa, and held multiple meetings with MFP technical teams led by Juan Blas and Jorge Lope, Director and Deputy Director, respectively, of Tax Policy and Analysis. Various meetings were also attended by officials from different areas of the Tax Administration Superintendency (SAT), headed by Alex Gonzalez, Chief of the Inspection Unit, and Emilio Pacay, Assistant to the Intendant. The mission also met with Vice-Minister of Economy Lisandro Bolaños from the Ministry of Economy and Trade. Lastly, the mission met with directors of business associations, AmCham Guatemala, the Coffee Exporters Association (*Asociación de Exportadores de Café – ADEC*), and the Apparel and Textile Association of Guatemala (*Asociación de la Industria del Vestuario y Textiles de Guatemala – Vestex*) as well as with executives of research institutions, ICEFI, and FUNDESA and with EY and PwC tax specialists.

The mission is grateful to all the authorities for their extensive and kind cooperation and for the efficient support provided by the IMF representative office and especially to Carol Cruz Alavarado for the assistance in preparing the mission agenda.

EXECUTIVE SUMMARY

This report discusses three topics central to international taxation in Guatemala: (i) the factors that the government must consider to establish a position on treaties for the avoidance of double taxation; (ii) the strengthening of the transfer pricing regime; and (iii) the potential effects that BEPS minimum standards might have on Guatemala and the likely changes in international tax architecture recently agreed upon by the community of countries under the OECD/G20 Inclusive Framework.

Treaties

The topic of treaties has garnered special attention in Guatemala as of late, requiring a strategy to be devised. Guatemala does not have treaties in force, despite signing one with Mexico in 2015 that it has not ratified. The decision that the Government of Guatemala must make is whether to promote the ratification of the treaty with Mexico and open the door to the negotiation of others. Treaties certainly have advantages, the main one being, in principle, the encouragement of foreign direct investment (FDI) between the contracting countries. However, treaties also entail costs because they typically reduce income source taxing powers, which has a particular impact on net capital importers such as Guatemala. The decision must ultimately respond to the treaty cost-benefit balance, and this partly depends on how and with whom they are negotiated and on the tax context within which they fall.

The Guatemalan context is of no help. First, tax collection is low, one of the lowest in Latin America, leaving very little room for additional tax sacrifices. The general tax regime for income from lucrative activities, including the simplified option based on gross income, is already competitive internationally. Second, the country offers considerable investment incentives, such as free-trade zones and the maquila regime, whose benefits are not clearly quantified, while reporting potentially understated tax expenditure.

To their credit, treaties foster a better business climate and can encourage FDI in sectors other than those already benefiting from special regimes. This would be welcome in Guatemala because its FDI quota is low, even for the Central American region. Treaties can also promote the expansion of certain businesses operating from Guatemala, especially export services, which can currently be subject to double taxation.

Nevertheless, the many empirical studies that have been conducted offer no conclusive results. The economic literature could not confirm a meaningful causal relationship between signed treaties and FDI, particularly for developing countries. The same applies to studies on Latin America.

A preliminary study estimates that the entry into force of the treaty with Mexico will have a positive effect. However, the results must be interpreted with caution: (i) FDI data are not the most reliable; (ii) the experience of other countries that signed treaties with Mexico, used as a

basis for modeling this exercise, are not necessarily comparable; (iii) the periods before or after the treaty are very short for enacting change in the investment growth trend; and (iv) the investment level is virtually nil at the beginning, which is why very small amounts of capital can represent a very high but analytically irrelevant percentage increase. The effect that the treaty could have on foreign investment can therefore be severely overestimated.

The literature points out that a key variable behind FDI flows is the countries' institutional stability and health. Guatemala ranks poorly in that regard on an international scale, which indicates that much remains to be done. To be successful, Guatemala may need to rethink its tax system to increase collection significantly, thus improving its institutions, infrastructure, and social spending. Treaties, which have a higher legal hierarchy than domestic legislation, can limit flexibility for a potential future tax reform. The decision to enter treaties should therefore be made in the context of a broader tax strategy.

At present, to enter into treaties, Guatemala requires the development of an own model that protects the right to tax income at source and to sign treaties with countries where a potential double-taxation problem might inhibit a likely flow of investment. Countries that have no income tax or even those that have territorial systems, such as Guatemala, with reduced withholding rates would be excluded.

The report explains the main differences between the OECD and UN model treaties and recommends that Guatemala use the UN model as its primary reference, which favors tax on the source of income. It is important for Guatemala to maintain the right to tax the payment of royalties to residents abroad and for the concept of royalty to include software use, specialized technical services, and equipment and machinery leasing. Various payments made abroad with a source in the paying country (royalties, dividends, and interest) normally have a limited definition in the treaty. For this reason, reference must be made to the definition of dividend and interest in domestic legislation. Legislation must support treaties with broad definitions. For example, the definition of interest must include financial operations derived from debt. For royalties, some concepts must be added in the treaty itself. Treaties must also include taxation at source for "other income" paid to residents of the other contracting state that is not business profit, since such profits are usually taxed only in the country of residence.

The treaty signed with Mexico basically follows the guidelines recommended in this report and is therefore very close to the model that Guatemala could adopt for its future negotiations should it opt to enter into treaties for the avoidance of double taxation. The treaty with Mexico also excludes an arbitration clause, which is the position that most developing countries have preferred. However, this treaty does not include the anti-abuse measures agreed in BEPS Actions 6 and 7 on treaty shopping and the circumvention of the concept of permanent establishment. This is why the treaty with Mexico should not be ratified under the current terms.

Domestic Legislation

Taxing power borders are defined, first and foremost, in domestic legislation. The definitions of source, residence, and permanent establishment, among other concepts, are key in that respect. The report examines some of these definitions, focusing on those issues that could potentially lead to double taxation or, conversely, weaken the country's tax base.

One important consideration is that Guatemala has a tax regime that is (almost) strictly territorial in nature; by definition, this regime exempts all income that resident persons earn abroad. This not only reduces the tax base that Guatemala can claim, but also potentially gives rise to an equity issue since higher earners will be those with access to this exemption. Moreover, personal income tax rates in Guatemala are very low, which could largely explain why Guatemala has the lowest collection of this tax in the region at less than half a percentage point of GDP. Extending the tax to foreign passive income of resident persons in the country and granting the corresponding credit for taxes paid abroad is a policy option that Guatemala could reconsider. With such an approach, a treaty would offer a more practical solution.

The legislation is cautious in defining source with regard to services provided by residents abroad since taxes are charged only when these services are used in Guatemala. Many countries charge taxes when the paying source is in the country, avoiding interpretation issues as to the place of use of the service. In such cases, potential double taxation would be resolved with a treaty. Other aspects of the legislation that could be modified to align with potential treaties are: (i) excluding activities of a purely preparatory or auxiliary nature as assumptions of permanent establishment; (ii) regulating the implementation of tax on indirect disposals of assets located in Guatemala; and (iii) eliminating the full exemption on interest paid to financial sector entities abroad (even when the tax incidence falls mainly to domestic debtors).

Transfer Prices

The regulation on transfer prices needs to be modernized. Treaties facilitate transfer pricing control because they allow the counterparty to change its prices in response to an adjustment by a taxpayer in Guatemala, thus avoiding double taxation. Many countries would not accept the adjustment from a country without a treaty. Taxpayers will be more willing to self-correct if the tax is shifted from one jurisdiction to another without increasing the overall corporate tax burden. However, for this mechanism to work, the legislation must prevent the SAT from only authorizing price adjustments if they are in favor of the Treasury.

The scope of the regulation must be widened. The obligation to comply with the arm's length principle (free competition) must also apply to domestic related parties, albeit in a simplified way, keeping the burden of proof with the authority. What must also be included is the related party presumption and the duty to comply with the same principle when taxpayers conduct operations with residents in low- or no-tax jurisdictions, especially if they are not very cooperative (in respect of which Guatemala will have to resolve its own problems to exchange information).

The regime for imports and exports must be replaced with a more functional one. As stated in the legislation, goods exporters and importers are currently required to apply the so-called “sixth method,” the implementation of which is unclear because the regulation does not clearly define the reference price to be used or the permitted adjustments. Taxpayers understand the method to be optional. This poses a potential dilemma for the SAT since, in theory, it must oversee a basically ineffective method. It is recommended that this method be replaced so that the legislation gives priority to the comparable uncontrolled price method and that this method be made compulsory only for a few commodities listed on stock exchanges or in organized markets.

The restrictions on interest deductions must be simplified. The legislation currently penalizes interest deductions in three ways: (i) through a thin cap rule, which is very lax; (ii) by prohibiting the deduction of interest paid to residents abroad other than regulated financial entities, which is very strict and discriminatory; and (iii) by limiting the deductible interest rate to the one determined by the Monetary Board for tax purposes, which is a very lax default rate. All of these rules can be replaced by a single one, in accordance with the international best practices identified by the draft BEPS project under Action 4, limiting deductions for total interest paid to a percentage of the taxpayer’s profit measure, for example, 30 percent of earnings before interest, taxes, depreciation, and amortization (EBITDA).

Other measures are also necessary to protect the tax base. For example, conditions must be established for the deduction of intra-group services for compliance with the “effective profit test” for the taxpayer, in addition to regulating the market valuation of royalties paid for the use or exploitation of intangible assets with more elements.

BEPS Minimum Standards

Lastly, the report discusses the BEPS minimum standards, highlighting Action 5 on harmful tax practices. This standard requires countries to eliminate regimes offering tax privileges to taxpayers that do not have much corporate substance and that encourage the shifting of profits generated in other jurisdictions. These harmful regimes generally attract financial activities or services (or the registration of intangible assets) in locations that are not very cooperative in exchanging information or very transparent about the benefits they provide. The latest agreed changes to the international tax system architecture, introducing a minimum global tax of 15 percent for multinational enterprises (Pillar 2), show that the countries’ sense of community is leaning toward banishing full exemption regimes for non-transparent businesses. The increase in special regimes in Guatemala might eventually risk running into this international trend.

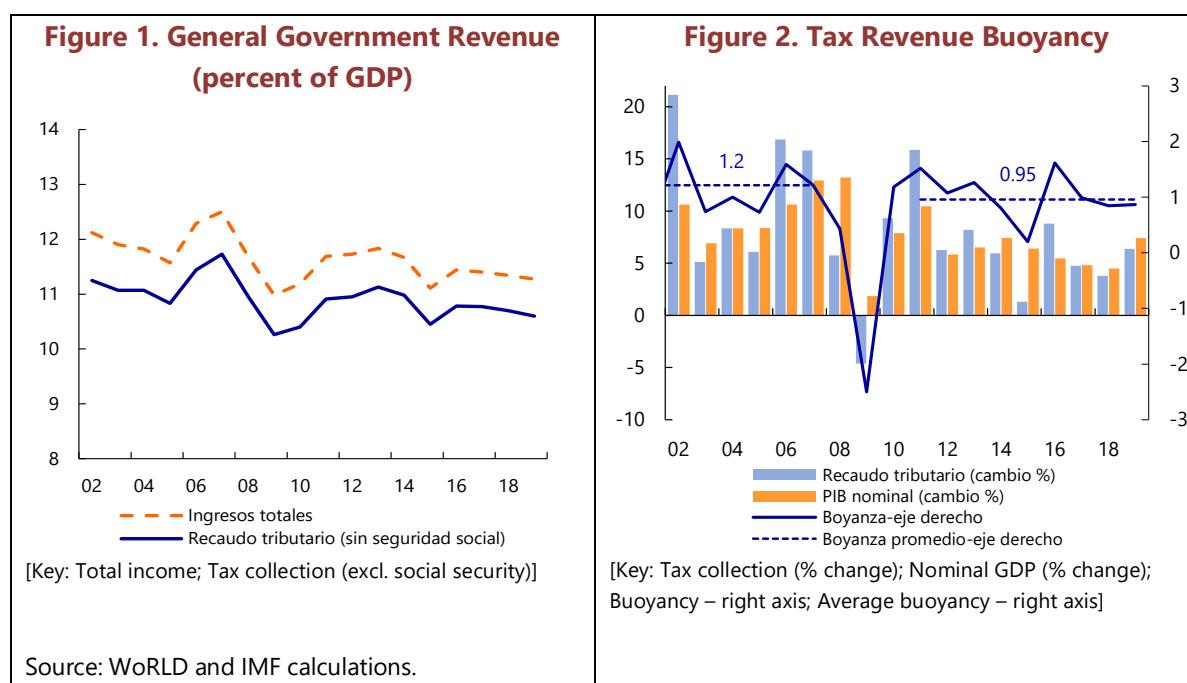
I. INTRODUCTION

1. **The Guatemalan Ministry of Public Finance asked the IMF mission to review three international taxation topics:** (i) the policy and model treaties for the avoidance of double taxation appropriate for Guatemala; (ii) the strengthening of the transfer pricing regime; and (iii) the consequences for Guatemala of the minimum standards on base erosion and profit shifting (BEPS) adopted by the G20 and the Organisation for Economic Co-operation and Development (OECD). These topics are discussed in the following manner.
2. **Chapter II of this report analyzes the tax revenue structure in Guatemala** to determine the context surrounding the discussion on international taxation as well as the (little) flexibility the country has to negotiate treaties, which can cost tax resources. The chapter also examines current preferential regimes to encourage investment in Guatemala and the tax expenditure involved.
3. **Chapter III reviews some basic concepts contained in domestic legislation on international taxation**, such as the definitions of source, residence, and permanent establishment, which determine the scope of the country's taxing power, focusing on aspects that could give rise to double taxation.
4. **Chapter IV of the report discusses which treaty model would strike the right balance for a net capital importing country like Guatemala.** FAD policy is not to intervene in treaty negotiations between the institution's member countries. Guatemala does not have current treaties, although it did sign but not ratify a treaty with Mexico, whose entry into force is still being discussed in the country. This chapter analyzes treaties in a general sense from the perspective of a developing country, without directly referring to the clauses negotiated with Mexico, except when comparing BEPS standards.
5. **Chapter V contains a summary of the extensive literature on the empirical relationship between treaties and foreign direct investment (FDI).** This is important background for guiding expectations that could arise from the potential signing of treaties, informing decisions in that regard. Some considerations specific to Guatemala are discussed.
6. **Chapter VI explores how the country's tax base can be strengthened by adopting international best practices on transfer pricing.** The chapter alludes to ways in which treaties facilitate the implementation of transfer prices. It also considers certain anti-abuse measures for cases where transfer pricing has difficulty yielding results.
7. **Chapter VII explains the BEPS minimum standards** and comments on their appropriateness for Guatemala, especially concerning preferential tax regimes. Lastly, it contains a brief explanation of the most recent Inclusive Framework agreements on international tax architecture reforms (Pillars 1 and 2) and offers some thoughts on how this could affect Guatemala.

II. TAX REVENUE STRUCTURE

A. Total Tax Revenue Compared

8. **Guatemala’s tax revenue has lagged over the past decade.** The general government’s total net collection, not including social security, accounted for 10.6 percent of GDP in 2019, which is lower than the average collection over the seven years preceding the 2008–09 financial crisis (Figure 1). Tax revenue in Guatemala did not keep pace with economic growth in general (Figure 2).¹ This temporarily worsened with the effects of the pandemic; tax revenue fell to 10 percent of GDP in 2020, but increased to 11.7 percent in 2021, mainly as a result of the economic rebound.² It has been said before that tax collection must be strengthened in Guatemala, particularly through measures that broaden the tax base, in order to create fiscal space for raising social and infrastructure spending.³



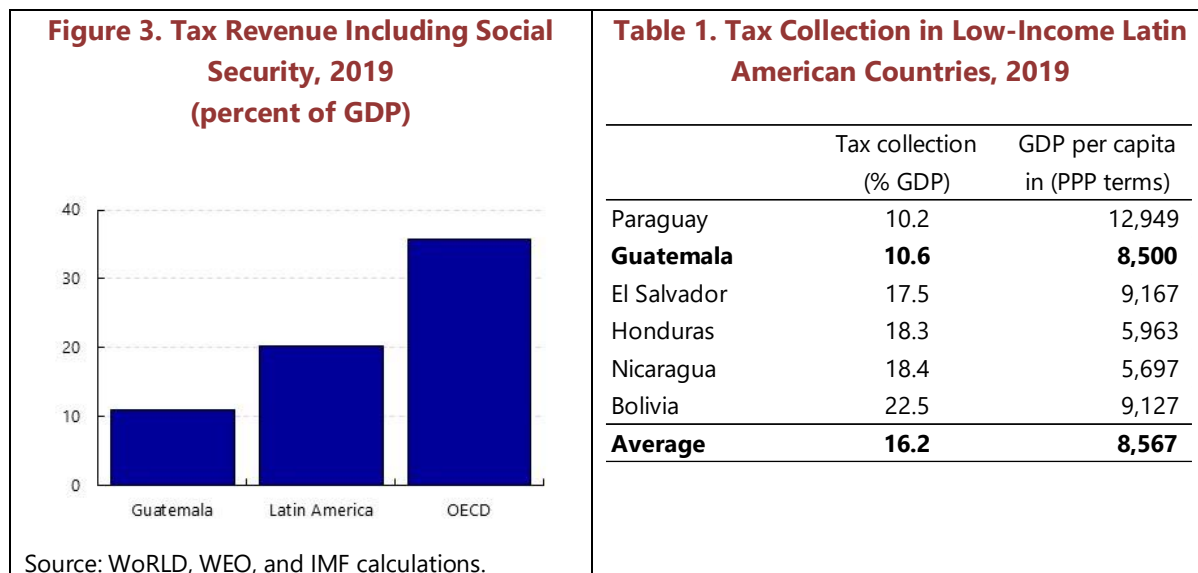
9. **Tax revenue in Guatemala is one of the lowest on the continent.** Collection has been roughly half of the Latin American average (Figure 3). Although tax revenue as a percentage of GDP is normally lower when per capita income is smaller, Guatemala has one of the lowest collection rates even among countries in the lower range of per capita income (Table 1). The

¹ The correlation between tax revenue growth and economic growth, called tax buoyancy, has been below 1 in Guatemala since 2011.

² Rising fuel prices influenced the 2021 figures, as did the payment of taxes for the sale of a telephone company, which alone meant a collection increase of 0.3 percent of GDP.

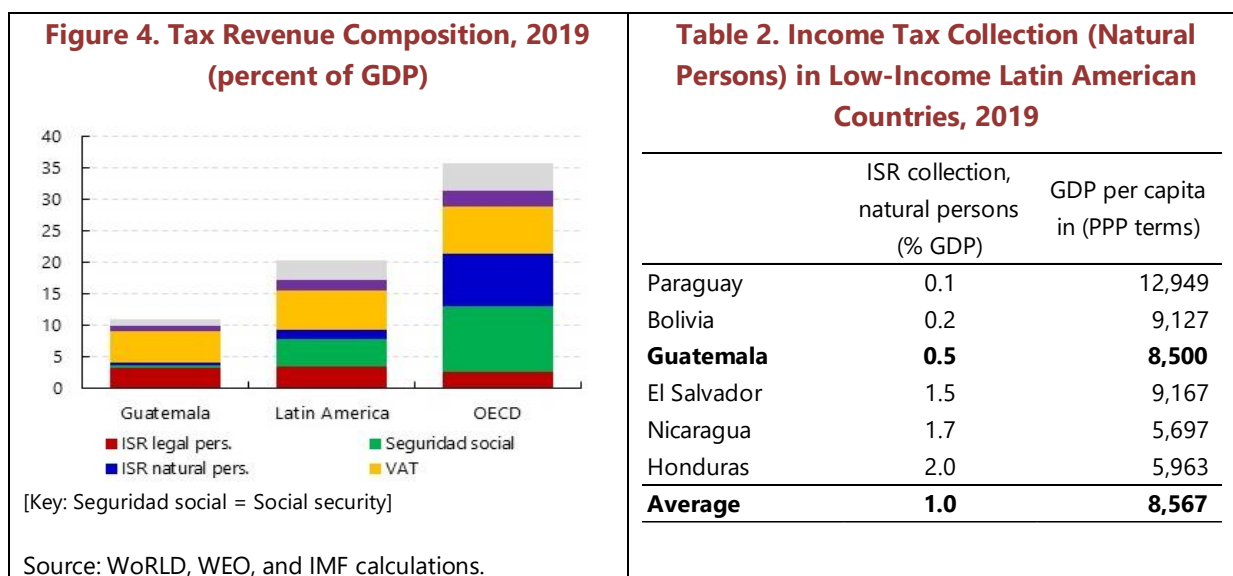
³ See IMF (2021).

weaker performance relative to the region is another indicator that Guatemala must make a greater effort to increase tax collection.



B. Tax Revenue Composition

10. **As is common in Latin America, the main taxes in Guatemala are value-added tax (VAT) and income tax (*Impuesto Sobre la Renta* – ISR) for legal persons.** These two taxes account for 77 percent of the country’s tax revenue (Figure 4). The most notable deficiency in Guatemala is in personal ISR, which in 2019 accounted for barely half a percentage point of GDP, one of the lowest in Latin America (Table 2). The average is four times this percentage for the region and double that if only low-income countries are considered.



11. **VAT is the most widely collected tax in Guatemala.** However, compared to other countries in the region, where VAT is also typically the largest tax,⁴ what Guatemala collects is fairly low. Average VAT collection in the region was just above 6 percent of GDP in 2019, compared to 5 percent in Guatemala. The weaker performance partly reflects a relatively low statutory rate of 12 percent, but also poor tax productivity.⁵

12. **VAT collection and the weak performance of personal ISR in Guatemala are connected to some extent.** Guatemala's tax regime has a unique feature that exists in few countries: up to a certain amount, the VAT paid by natural persons is deductible from (and partly creditable against) their ISR.⁶ This encourages the payment of VAT and reduces the ISR base.⁷ Although a limit has been in place on the deductible (and creditable) amount since 2012, the regime continues to be in effect and introduces a bias against personal ISR.

13. **The revenue collected in Guatemala through corporate ISR is comparable to the region's average.** In 2019, collection amounted to 3.2 percent of GDP, a couple of tenths below the regional average (Table 4). The general regime rate (25 percent) is competitive, falling within the lower limit of the range of rates prevailing in Latin America, except Paraguay (Table 4).

⁴ With the exception of Mexico (which has a significant portion of the base subject to a rate of zero) and Panama (the only country with a single-digit VAT rate).

⁵ VAT efficiency in Guatemala is 0.43, which is low compared to most countries in the region and below the average (0.66) of Latin American countries with a comparable per capita income level.

⁶ There is a "blind" per-person deduction of Q 48,000 (LISR, Art. 72, para. (a)). The tax paid at a rate of 5 percent, applied to an additional amount of up to Q 12,000 (that is, Q 600), is creditable against the ISR. The mechanics of this second limitation are not established in law, but are derived from the SAT-1431 employee forms and the SAT-1111 VAT spreadsheet, which must be filled out to access the benefit.

⁷ See FAD reports (2016, 2017). It is worth noting that, despite the introduction of the upper limit to the creditable amount, ISR collection from natural persons has not improved substantially. It rose from 0.40 percent of GDP in 2012 to 0.46 percent of GDP in 2019. A detailed analysis of this topic is beyond the scope of this report, which focuses on international taxation.

Table 3. Corporate Income Tax

	Collection (% GDP)	Statutory rate
Dominican Republic	2.1	27
Panama	2.3	25
Paraguay	2.4	10
Uruguay	2.5	25
Brazil	2.8	34
Costa Rica	3.0	30
Guatemala	3.2	25
Mexico	3.3	30
Honduras	3.6	25
El Salvador	3.6	30
Peru	3.8	30
Bolivia	3.8	25
Colombia	4.0	33
Chile	4.8	25
Nicaragua	6.3	30
Average	3.4	27
Average of low-income countries /1	4.0	24

Source: WoRLD and IMF calculations. 1/ Ecuador was not included due to a lack of data.

C. Special Regimes

14. **Guatemala has various special ISR regimes.** All ISR taxpayers have the option of paying the tax through an alternative arrangement called “simplified optional” for lucrative activities, with a maximum rate of 7 percent on gross income (LISR, Art. 43–44)⁸ and an exemption from the Solidarity Tax (*Impuesto de Solidaridad* – ISO).⁹ It is difficult to estimate whether a regime of this type (with a relatively low rate that taxes gross income) puts more or less tax pressure than the general regime (which taxes profits at a higher rate) since the incidence will change from one taxpayer to another depending on their profit margin. Nevertheless, in the case of an optional (annual) regime, the taxpayer can be assumed to choose the regime with the lower tax burden. This means that the option will imply a decrease in collection, as long as the third option is not informality.¹⁰

⁸ Income up to Q 30,000 is taxed at 5 percent, whereas any income above that is taxed at 7 percent.

⁹ The ISO is a minimum direct tax on the gross income of natural or legal persons that carry out commercial or agricultural activities in Guatemala. The tax is 1 percent on a fourth of the gross income reported and is creditable against the ISR. It is understood to be an “advance” of the ISR.

¹⁰ In 2021, the simplified optional regime collected Q 6,359 million, representing a little under 50 percent of what was collected by the ISR in total. In previous years, 2015 to 2020, this regime contributed on average 56 percent of corporate ISR collection (lucrative activities). In 2020, 245,000 taxpayers paid tax under the optional regime,

15. **Guatemala also has special regimes for promoting investment.** The top ones are the free-trade zone, free zone, and maquiladora regimes.¹¹ The main benefits are: (i) *temporary suspension* (for one year) of import tax, including VAT, on inputs used in the manufacture (assembly or repair) of goods intended for export and goods imported for re-export; (ii) *exemption* from import tax, including VAT, on machinery and equipment as well as from special consumption taxes on fuel imports;¹² and (iii) *full exemption* from ISR for 10 years.¹³ In addition, the purchase of domestic inputs by maquila entities and free-trade zone users is *exempt from VAT*.¹⁴

16. **This class of tax benefits is common in the zone.** However, these preferential regimes carry certain risks: one, collection favoring investment that would have happened anyway is lost¹⁵ and, two, the regime is exploited by transnational companies to conceal income actually derived from activities that take place in another territory (with higher taxation). This latter situation could result in preferential regimes being classified as harmful by the Forum on Harmful Tax Practices¹⁶ and their beneficiaries being potentially subject to defensive measures by the affected countries (for example, increase in withholding rates for payments to regime beneficiaries).

D. Tax Expenditure

17. **Tax expenditure is the amount of revenue that the government fails to collect as a result of the preferential treatment it grants to a group of taxpayers.** The expenditure is normally estimated based on the amount of tax the group of benefiting taxpayers would have

which accounted for a little over 60 percent of the total. This option for defraying the ISR from lucrative activities is a preferential regime insofar as it captures taxpayers who could be paying tax under the general regime. Nevertheless, the regime could be considered to collect tax if those who opt for it would otherwise have been informal. There is no clear answers to this question, but it should be noted that informality in Guatemala is high compared to the region. The percentage of employment in the informal sector is estimated to be greater than 70 percent for 2017, above the Latin American average of 50 percent. See FAD (2017) and World Bank (2021).

¹¹ Decree 22-73 (Santo Tomas de Castilla Industry and Commerce Free Zone), Decree 29-89 (Law for the Promotion and Development of Export and Maquila Activities), and Decree 65-89 (Free-Trade Zone Law). The ISR exemption for maquilas is limited to the textile and apparel industry and to "information" and "communication" services. At present, the list of admitted specific services includes call or contact centers, software development, and digital content development, as long as their services are provided to non-residents (Government Agreement 3-2017, Art. 5). Free-trade zones admit a broader range of services. The provision of financial, telephony, television, and radio services is prohibited. In 2022, the criterion was relaxed (Government Agreement 65-22) to include new activities, such as hospital services.

¹² The benefit is only for fuels used in production located in the free-trade zone or authorized under the maquila program.

¹³ The benefit does not apply to entities domiciled abroad with branches, agencies, or permanent establishments in Guatemala, which receive a credit for ISR paid in Guatemala.

¹⁴ Free-trade zone *administrators* enjoy similar tax benefits to those of *users*.

¹⁵ See PCT (2015).

¹⁶ Forum sponsored by the OECD responsible for verifying compliance with BEPS Action 5 to combat harmful tax practices considering the transparency and substance of the activities accessing tax privileges. See Chapter VII of this report.

paid under the general regime. Every year, the SAT calculates the tax expenditure for the various tax privileges that exist in Guatemala, according to the type of tax and the beneficiary. For 2020, the SAT estimated a total tax expenditure of 2.7 percent of GDP, two thirds of which came from consumption taxes (Q 10.6 billion – Table 5). The tax sacrifice that special maquila, free-trade zone, and free zone regimes would entail would be relatively minor, representing 6 percent of the total tax expenditure for this year, equivalent to 0.16 percent of GDP. These regimes would mainly benefit from a direct tax exemption, adding a benefit of a little over Q 500 million that year, barely 10 percent of the total tax expenditure in direct taxes.

18. **The estimated tax expenditure from preferential regimes to encourage investment seems modest.** However, the amount could be underestimated. Assuming that all garment exports originate from maquila benefiting from the special regime and that, in the absence of such a regime, the industry would pay the simplified optional ISR, the proceeds would have totaled around Q 650 million in 2020,¹⁷ approximately 30 percent more tax expenditure in direct taxes estimated for all the beneficiaries of the three special regimes.¹⁸

Table 4. Tax Expenditure of Key Taxes Administered by SAT, 2020
(in millions of quetzals)

	ISR	ISO	Direct	VAT	TOTAL	Structure (% total)	% GDP
Beneficiaries D 29-89 (maquila)*	330	55	385	471	856	5.3	0.1
Beneficiaries D 65-89 (free-trade zones)*	87	33	120	0	120	0.7	0.0
Regime subtotal	417	88	505	471	975	6.0	0.2
Other	3937	480	4417	10174	15195	94.0	2.5
TOTAL	4354	568	4922	10644	16170	100.0	2.7

Source: SAT,* includes Zolic.

19. **In sum, the current ISR general regime in Guatemala is, at first glance, internationally competitive and has comparable collection.** One question is whether there is room to sign treaties for the avoidance of double taxation that might reduce this collection. In principle, there is no space for Guatemala to lose even more ground in its tax revenue. It also seems unlikely that a loss in corporate ISR collection could be easily replaced with higher collection of other taxes.

20. **Guatemala’s tax system offers very generous special regimes.** These regimes can not only make other FDI promotion instruments redundant, but can also constitute harmful

¹⁷ 7% X (2020 clothing category export value) US\$1.2 billion X 7.72 (2020 parity) = Q 655 million.

¹⁸ The SAT estimates this tax expenditure using as a reference the profit margin of comparable companies that file taxes under the general regime. It applies this margin to the maquila cost and expense base to obtain the exempt ISR base, which provides the sector’s tax expenditure after being multiplied by 25 percent. However, this method may undervalue the estimate since maquila typically operates with inputs and assets in consignment, property of the purchaser of maquila services, which is why they are not included in the cost and expense base. If the maquila cost and expense bases and the base of maquila comparables were standardized, the forgone tax base would likely be considerably higher.

preferential regimes. This report discusses ways of bolstering safeguards for corporate ISR internationally to protect the tax base and the treaty model that could minimize the sacrifice of the said base, without neglecting the objective of promoting FDI.

Recommendations

- Conduct a more comprehensive assessment to establish a long-term policy for strengthening tax revenue in Guatemala.
- Reconsider the methodology for calculating the tax expenditure associated with special regimes.

III. INTERNATIONAL ASPECTS IN THE INCOME TAX LAW (LISR)

21. **This chapter reviews how the local ISR standard ties to some aspects of international taxation.** This review places special attention on situations with the potential for double taxation and double non-taxation and some situations that may conflict with the eventual application of conventions for the avoidance of double taxation that Guatemala might enter into.

A. Territorial Regime Versus Global Income

22. **Guatemala has a territorial system that taxes only local source income.** It covers all income generated in the territory of Guatemala, including interest, royalties, services, and capital gains (LISR, Articles 3 and 4 of Decree 10 of 2012). The alternative to this system is a tax regime that taxes the worldwide income of its residents, in addition to domestic source income generated by residents abroad operating in the country.

23. **The territorial system has various advantages, especially for developing countries.** This system is simpler since taxpayers are not required to report, and the Treasury to control, foreign source income. The territorial system also does not require the implementation of measures to avoid international double taxation as a mechanism for crediting taxes paid abroad. Cases of international double taxation can nevertheless exist (as is the case with services, explained later).

24. **Territorial regimes also have significant weaknesses.** The tax base is smaller because all resident incomes generated outside the country are not affected by the ISR (in the country of residence). For the same reason, the regime can be more contentious regarding the interpretation of the meaning of local source and limits information to what the tax authority can access.

25. **Although a territorial system seems appropriate for a country with limited administrative resources and low capital exports, it also raises an equity issue.** This is a major consideration for developing countries. Higher earners could more easily take advantage of opportunities to relocate their income sources and be ISR-exempt. This, coupled with the benefits offered by low- or no-tax countries, can produce conditions conducive to double non-taxation of income.

26. **Many countries that have moved toward a territorial regime did not completely abandon the global income regime they originally had.**¹⁹ World income rules are often kept for personal ISR, whereby passive income (dividends, interest, royalties, or capital gains) earned

¹⁹ Worldwide income regimes were not absolute either in practice. The profits of subsidiaries abroad are normally taxed when they are repatriated, deferring the tax indefinitely.

abroad is taxed, for example. It is also common for countries to maintain taxation of passive income earned abroad by entities controlled by a resident legal person. In both cases, the regime provides credit for tax paid abroad up to the domestic tax limit. This is a standard recommended by Action 3 of the BEPS project (OECD 2015a).

27. **In the end, the most appropriate regime is the one that strikes the best balance between the advantages and drawbacks of each regime.** For the time being, Guatemala has preferred a territorial system, assuming the costs this entails, one of which is that personal ISR collection is very low. However, this system generally eliminates double taxation for its residents (one of the reasons for negotiating treaties for the avoidance of double taxation).

B. Definition of Source

28. **The definition of source establishes Guatemala's taxing right over resident and non-resident incomes generated in the national territory.** As is common, domestic source income is defined as income generated by the production, sale, and marketing of goods and services in Guatemala and the export of goods and derivatives of capital and capital gains generated in Guatemala. Dividends, withdrawals from permanent establishments, interest, and royalties paid from Guatemala to a resident abroad are also considered to be sourced in the country. The source of payments abroad for services follows a similar fate, but has one peculiarity.

Services

29. **Services provided by a resident abroad are locally sourced when they are provided in Guatemala or when they are provided abroad but used in Guatemala.**²⁰ This means that services paid for in Guatemala but not used in the country are not locally sourced, leaving room for circumvention since the concept of service use in the country is debatable.²¹ Royalties, for example, are considered locally sourced when they are *paid or used* in the national territory.²² The standard on services makes double taxation of residents abroad less likely and therefore makes a treaty to achieve this result less necessary. However, in the absence of a treaty, double taxation in the opposite case is not avoided if the other country, the source country in this example, taxes services as long as they are paid for in its jurisdiction.

²⁰ LISR, Article 4, paragraph (f). "Legal, technical, financial, administrative, and other assistance services used in the national territory that are provided from abroad to any individual or legal person, entity, or estate residing in the country as well as the permanent establishments of non-resident entities."

²¹ A service provided abroad but used in the country could apply to company employees participating in a training course in another country (paid for in Guatemala) and returning to the country to make use of their new knowledge. Payment for the training service would be subject to withholding in Guatemala in this case. Conversely, a Guatemalan visitor to a neighboring country who pays for repairs to his car (and does so with his credit card, such that the payment is made from Guatemala) may be a case of a service paid for in Guatemala but used abroad and therefore not sourced in Guatemala.

²² The definition of royalties under No. 3 of Article 4, paragraph (c), No. II, encompasses rights or licenses for computer programs or their upgrades and, under No. IV, information relating to industrial, commercial or scientific knowledge or experience (know-how).

Interest

30. **The definition of interest source adheres to the strict logic of a territorial system and, in practice, entails certain risks.** Exempting financial returns in Guatemala that were obtained abroad creates an incentive to export capital and, although the territorial regime is based on the premise that these returns will be taxed in the source country (or where the payer of the interest resides), many countries that are major financial centers exempt from tax the financial investments of non-residents. This is a situation of double non-taxation. There is also a lack of clarity in the law as to whether payments made by residents for derivative financial transactions (debt instruments) are subject to interest treatment²³ and whether they are Guatemalan source income. Clarifying their treatment would broaden the tax base and would help to apply the tax conventions that might be signed.

Dividends

31. **The territorial regime can also encourage evasion.** A company residing in Guatemala that distributes dividends must withhold from the shareholder a 5-percent tax (whether the person is a resident or non-resident of Guatemala). However, the company can instead make a loan to an entity abroad (owned by the same shareholder) and thus evade the withholding. The first line of defense against this scheme (which would operate the same way in a global income regime) is for loans to shareholders to be marked as dividends and be made subject to the corresponding withholding. Many countries take the precaution of adopting a specific anti-abuse rule on the presumption of profit (dividend) withdrawals. Guatemala does not have one. Guatemala only has an anti-abuse rule of substance over form, the application of which is more complex and applicable in the context of transfer prices (LISR, Art. 61). The second line of defense in a global income regime scenario is for interest generated by such a loan to be taxed in Guatemala, whereas in a territorial system, this interest could be paid to a resident tax-free.²⁴

Capital Gains

32. **The law establishes a general rule whereby capital gains and income derived from movable and immovable property in Guatemala are considered to be locally sourced.** This includes income and capital gains derived from the disposal of shares (rights or interests) in a resident or non-resident entity whose assets consist of immovable property located in Guatemala.²⁵ This is a broadening of the definition of own source under a strict territorial system since it taxes the earnings of a resident abroad from the disposal of shares of a non-resident company when related to the enjoyment of assets located in the country (indirect sale of assets).

²³ Article 4, No. 3, paragraph (b).

²⁴ The opposite can also be problematic when investment funding from abroad is presented as a loan, even if it has the characteristics of a capital contribution, such that the return paid abroad is a deductible interest instead of a dividend which is not. This is discussed in Chapter VI.

²⁵ LISR, Article 4, paragraph (f). The definition does not include financial operations derived from capital.

33. **Taxing indirect sales closes a major avenue of tax avoidance.** However, this is a complex provision to implement and requires detailed definitions of how the tax should be calculated and charged. The first consideration is to determine the taxable base when assets located in Guatemala are only part of the assets of the non-resident company subject to the indirect sale. The entity responsible for paying the tax must also be identified. There are different mechanisms for this, one being that the selling company is responsible, even if it is not a local resident. This option is very difficult to control and makes collection of the tax highly unlikely. For that reason, when a local company is alienated through an indirect sale, the buying company can alternatively be subjected to the tax (under the obligation to withhold tax at the time of acquisition) and the obligation can be made effective through the alienated company residing in the country.²⁶ None of this is regulated in the local regulation taxing the indirect sale of immovable property located in Guatemala.

34. **One particularity in the application of the territorial regime to the receipt of dividends from foreign sources is that the effect varies depending on when the dividend is received by the resident.** The direct or immediate (resident) recipient of the dividend is exempt from such income. If this person is the ultimate shareholder of the foreign entity, the territorial system functions as expected (exemption). However, if the immediate shareholder is another entity that redistributes the dividend to the ultimate shareholder (resident), such distribution will be taxed since it will be considered to be a distribution from a domestic source, despite the entirely foreign origin of the income. This prompts residents to have holdings outside the country in order to control their investments abroad. Such situations would disappear if Guatemala were to adopt the standard under BEPS Action 3 and tax passive income earned abroad by domestic residents.

C. Definition of Residence

35. **The legislation defines residents as natural persons who spend more than 183 days during a calendar year in the national territory** or when their center of economic interests is located in Guatemala. In this latter case, taxpayers who prove their residence or tax domicile to be in another country by way of a certificate issued by the tax authorities of that country are exempt.²⁷

36. **In general terms, this definition of resident for natural persons is consistent with international practice, with one important caveat.** The exemption granted when the person has a residence certificate issued by another country could cause control problems, especially when there are difficulties exchanging information. The door remains open for a taxpayer to obtain a certificate from a lower-tax country where the requirements to obtain residence are

²⁶ See Platform for Collaboration on Tax (2019).

²⁷ Article 6 of the Law.

more lax.²⁸ The problem is exacerbated in circumstances involving a convention because it would affect the taxing powers under the convention.

37. The calculation of days in the country during a calendar year can be manipulated.

Staying one of the 183 days during the year immediately before or after would be enough for someone to be declared a non-resident. That is why the rule established by many countries is that a person is considered a resident if they spend this number of days in any 12-month period.²⁹

38. The definition of residence for legal persons under the LISR follows the international standard. Entities established in the country, those that have their registered office or tax address in the national territory, or those that have their center of effective management in the national territory are considered residents. Both are criteria accepted in international conventions.

D. Definition of Permanent Establishment

39. The definition of permanent establishment in the Law³⁰ is consistent with that of the OECD and UN Model Conventions,³¹ except for one situation. A permanent establishment occurs when a resident abroad has a place of business in Guatemala or is presumed to have one through the relations the resident maintains with dependent or, in some case, independent agents. Guatemala's rule is standard up to there, but the provision departs from the international norm by not excluding from the definition of permanent establishment activities of a preparatory or auxiliary character.³² This could result in double taxation, with the additional complexity of having to attribute an income to such activities. A treaty would likely remedy the problem, but only for residents of the contracting State. Amending the law would correct this for all investors.

40. Permanent establishments are taxed according to general rules. Permanent establishments in Guatemala are taxed on local source income attributable to them; there is no "force of attraction" rule for a permanent establishment that allows income earned directly in the country by the non-resident person associated with the permanent establishment to be attributed to that permanent establishment. Moreover, the expenditures of permanent establishments with their parent companies are deductible pursuant to general rules, including

²⁸ The risk is likely lower due to the low ISR rates in Guatemala for natural persons.

²⁹ The person would be a resident during the calendar year in which he or she spent the 183 days.

³⁰ Article 7 of the Law.

³¹ Article 5, OECD and UN Model Tax Conventions.

³² In accordance with the OECD Model Convention (Article 5, paragraph 4), the definition of permanent establishment excludes the use of facilities solely for the purpose of storage, display, or delivery of goods or merchandise belonging to the enterprise as well as various circumstances considered to be more of a preparatory or auxiliary character.

royalties and interest, which can be difficult to oversee as these are transfers within the same legal entity.

E. Withholding Rates on the Income of Non-Residents

41. **Non-residents without a permanent establishment are taxed on certain income generated in Guatemala.** The rates range from zero (financial sector interest) to 25 percent (“other income”), depending on the nature of the income (Table 5).³³ The non-resident’s gross income is taxed, but if the payment represents foreign marginal income, the rate taxes the profit for practical purposes. Therefore, the rates on interest, royalties, and technical services are advantageous relative to the tax rate used for income of the same nature earned by residents. However, there is equal treatment for capital gains, since the same 10-percent (preferential) rate applies to both residents and non-residents.

Country	Dividends	Interest	Royalties	Services	Capital gains
Guatemala	5	0 / 10 ⁽¹⁾	15	15	10
Mexico	10	4.9 / 10 / 15 ⁽²⁾	21 / 35 / 40 ⁽³⁾	25	25 / 35 ⁽⁴⁾
El Salvador	5 / 25 ⁽⁵⁾	10 / 20 / 25 ⁽⁶⁾	5 / 20 / 25 ⁽⁷⁾	20 / 25 ⁽⁸⁾	10
Costa Rica	5 / 15 ⁽⁹⁾	0 / 15 ⁽¹⁰⁾	25	25	15 / 30 ⁽¹¹⁾
Dominican Republic	10	10	27	27	27
Honduras	10	10	25	25	10

(1) Financial entities / other interest

(2) Financial entities and bonds / financial entities foreign states / reinsurers

(3) Machinery and equipment suppliers / general / tax havens

(4) Public listed companies / tax havens

(5) Gross income / earnings

(6) Bank deposit payments / other / tax havens

(7) Payments for intangible assets / other / tax havens

(8) Payments outside tax havens / tax havens

(9) Dividends paid by public listed and registered companies / tax havens

(10) Payments to bilateral or government entities / payments to others

(11) Reduced rate for earnings under certain thresholds / agreed statutory rate

42. **Tax withholding rates in Guatemala are relatively low compared to other countries.**

The rates established in the domestic law of countries in the region are normally 5 to 10 percentage points higher. This leaves these countries room to reduce rates if they sign any treaties. Guatemala has much less room to do so. As a matter of fact, the treaty with Mexico (signed in 2015 but not yet ratified) kept the rates established in the Guatemalan domestic law. The withholding rates in Guatemalan law are similar to those agreed in treaties by the region’s countries.³⁴

³³ Table 5 does not include withholding on other income.

³⁴ For example, the lowest withholding rates agreed by El Salvador, the Dominican Republic, and Costa Rica for interest and royalties is 10 percent, except that Costa Rica negotiated 5 percent for financial sector interest, which is anyway higher than the prevailing rate in the Guatemalan law.

43. **Entering into tax conventions without reducing the withholding rates established in the law should not result in a revenue loss for Guatemala, if the definition of source is protected.** However, signing conventions with the same withholding rates as those already enshrined in domestic law also does not serve as a major incentive for foreign investment in the country.

44. **The Guatemalan law unilaterally grants (regulated) financial sector entities a full exemption from withholding on interest payments.** Although lower withholding on interest reduces the cost of financing for a capital importer, fully exempting the latter seems like an excessive and uncommon benefit. In the region, only Costa Rica has a similar treatment. This also creates an incentive for the performance of back-to-back operations, which are difficult to control.³⁵

F. Deductions

45. **Guatemala only allows for the deduction of interest paid abroad when loans are granted by banks or financial institutions recognized in the country of residence.** This limitation is discriminatory according to the Conventions (Article 24 of the Model)³⁶ because the same transaction with a domestic counterparty is deductible, even if the creditor is not a financial institution. It would, however, be advisable to limit the deduction of interest paid abroad when dealing with back-to-back arrangements intermediated by financial entities.

46. **The deduction of payments abroad for technical services is limited to 5 percent of the taxpayer's gross income.**³⁷ This is also contrary to the non-discrimination clause of the Conventions. These types of caps on deductions are not an efficient mechanism for protecting the country's tax base because they can be very lenient and allow for significant profit shifting in some cases and very strict in others. What is appropriate is for the deduction to be consistent with the arm's length principle. However, in countries with low administrative capacity, the limit may be advisable and its elimination may involve a revenue loss if a convention is signed. Some countries have managed to protect this restriction by incorporating grandfathering³⁸ rules into their conventions, safeguarding their right to maintain them despite the non-discrimination clause.

³⁵ A back-to-back arrangement is, for example, when a parent company abroad deposits funds in a foreign bank so that the bank can use them to grant a loan to a company in Guatemala. The interest can be reclassified as dividend distribution, which is non-deductible and subject to 5-percent withholding. The comprehensive treatment of the deduction of interest is discussed in Chapter VI.

³⁶ See paragraph 4 of Article 24 of the OECD and UN Model Conventions.

³⁷ See No. 23 of Article 21 of the Law.

³⁸ See, for example, the Chile–Norway treaty.

Recommendations

- Tax financial income from abroad earned by resident companies and natural persons, including dividends, interest, royalties, and capital gains received either directly or through foreign companies controlled from Guatemala.
- Expand the source of services to include all those provided abroad but paid for in Guatemala, avoiding the need for interpretation as to whether or not they are used in the country.
- Define in the law the tax treatment of derivative financial operations so that they follow the fate of their underlying, that is, debt or capital.
- Define in the law the applicable regime and the parties subject to tax on capital gains from indirect sales abroad of immovable assets in Guatemala.
- Consider loans to partners (or relatives) as dividend distribution.
- Determine residence based on location of stay over the course of 12 calendar months.
- Eliminate proof of residence abroad with a certificate issued by a foreign authority.
- Align the definition of permanent establishment with international practice, excluding merely preparatory or auxiliary activities.
- Introduce in the law a force of attraction option for income obtained in the country directly by a non-resident that also has a permanent establishment in Guatemala.
- Reclassify back-to-back operations as profit sharing, not deductible and subject to dividend withholding.
- Consider maintaining deduction limits by incorporating grandfathering rules into conventions.
- Reconsider the zero percent withholding rate on the payment of interest to resident financial entities abroad.

IV. MODEL TREATY FOR GUATEMALA

A. Introduction

47. **The key objective of treaties for the avoidance of double taxation is to assign taxing powers** on income generated by persons or entities operating in more than one State. Double taxation results from an uncoordinated international distribution of income (or wealth) tax that impedes the movement of capital, persons, and services, affecting investment and potential economic growth.

48. **The global network of treaties is very extensive and includes a large number of developing countries.**³⁹ Guatemala currently has no treaty in force and signed only one with Mexico in 2015, which has not been ratified by the Guatemalan congress. At present, there is significant pressure on the government to negotiate new treaties based on the argument that this would help attract more foreign investment to the country. However, the decision is not an easy one because the various pros and cons of treaties, which differ depending on the counterparty and terms, must be weighed.

49. **These treaties also have costs, especially in terms of tax revenue.** The negotiation of treaties without full regard for their consequences could create harmful effects for collection. Treaties limit a State's taxing power and might create situations in which some income benefits for no reason from a fiscal policy standpoint or even situations of double non-taxation of a resident abroad.⁴⁰ To justify interest in a treaty, the possibility that residents of one State will be subject to double taxation on their income sourced in another State will have to be analyzed. A country with a territorial regime, such as Guatemala, does not expose its residents to double taxation. There is also an administrative cost; the authority must employ and train a team of experts to not only negotiate treaties, but also maintain them (oversight of the correct application of the convention, consultations, mutual agreements, litigation, etc.).⁴¹

B. Treaty Benefits and Drawbacks

50. **No answer can be provided beforehand as to the benefits and drawbacks of signing treaties to avoid double taxation.** One key question is the collection cost of entering into such agreements. The tax impact can be immediate and significant where there is a considerable, regular flow of payments to residents in the other contracting State and where the treaty reduces

³⁹ At end-2014, there were approximately 3,000 signed treaties, two thirds of which included a developing country. See M. Hearson (2015), *Introductory Note on the Action Aid Tax Treaty Data Set*, available at [11STM Note Hearson.pdf \(un.org\)](#). The database for 2022 reports 3,500 signed treaties, with the same proportion of developing countries.

⁴⁰ Double non-taxation could arise for activities exempt in free-trade zones, for example, because ISR is not charged and dividend distribution is not taxed for residents abroad.

⁴¹ This report does not delve into the administrative aspect of treaties, which would require a specific mission on that topic.

the withholding rates. This first effect can, however, be offset over time if FDI in the country increases enough.

51. **Treaties have the following main benefits:**

- *Legal certainty* – International treaties normally have a higher hierarchy than ordinary country laws, protecting the tax treatment of income or gains covered by the treaty. Unilateral changes in the law would not affect it.
- *Reduction of double taxation* – They guarantee lower withholding rates and exemptions not provided for in domestic legislation, reducing the possibility of double taxation.
- *Administrative cooperation* – They lay the foundations for cooperation between tax authorities to combat tax evasion and avoidance through clauses on information exchange and tax collection assistance.
- *Dispute resolution* – They offer an additional layer of defense besides those provided for in internal legislation. Taxpayers can request the initiation of a Mutual Agreement Procedure (MAP), which allows the competent authorities to discuss and resolve matters relating to the application or interpretation of the treaty.
- *Elimination of discriminatory treatment* – They prohibit discriminatory treatment that may exist in local legislation by reason of nationality or residence, such as the treatment of residents in connection with permanent establishment or discriminatory treatment of subsidiaries of foreign companies compared to domestic companies.

52. **There are also arguments against treaties.** The main one is the potential collection loss for capital importing countries due to lower withholding rates and ISR base limitations if the effect is not offset by higher FDI. It is also important to note that preferential regimes could wipe out much of the positive effect that FDI has on collection.

53. **Treaties should not be negotiated with countries that have an insignificant ISR.** It is common for countries to seek these types of treaties when there is no double taxation to avoid. At times, the beneficiaries of the treaties are a few public entities of the requesting country, for example, some sovereign wealth funds, which are not normally subject to taxation. These therefore claim a double benefit.

54. **A poorly negotiated treaty triggers aggressive planning schemes that are much more difficult to root out.** Terminating an existing treaty can have undesirable repercussions for bilateral relations. Tools to fight tax evasion and avoidance, such as information exchange and tax collection assistance, are contained in specific treaties on the subject, which is why this section of treaties for the avoidance of double taxation can be repetitive.⁴²

⁴² Guatemala is a signatory to the Convention on Mutual Administrative Assistance in Tax Matters.

C. Precautions Ahead of Treaty Negotiation

55. **Before the treaty negotiation process is initiated, a precise diagnostic assessment must be carried out on the real needs for treaty adoption.** The country must determine the cost it is willing to accept in exchange for receiving the estimated benefits. It is therefore crucial to understand the interaction between the treaty and the domestic laws of the states involved and to measure the consequences and limitations that a treaty imposes. Carefully selecting the countries with which to negotiate is also important insofar as the treaty resolves situations of double taxation.

56. **Major payments to residents abroad and foreign investment flows must be identified.** The starting point is to determine the major payments being made abroad, the countries to which they are being made, and whether they are being made to related parties. These details help measure the initial impacts that a treaty might have. What must also be determined is the origin of the foreign investment and the sectors for which it is intended, taking account of the fact that simple statistical projections can be unreliable (this is discussed in Box 1).

57. **Once the decision has been made to initiate the negotiation of a treaty with a certain State, it is necessary to gain an understanding of the latter's tax system** and how a tax treaty would interact with its legislation and to review the history of other treaties it had negotiated to strengthen Guatemala's position at the negotiating table.

D. Model Convention for the Avoidance of Double Taxation

58. **Two model conventions are most commonly used by countries.** The first is the OECD Model Tax Convention on Income and on Capital (OECD Model) and the second is the United Nations Model Double Taxation Convention between Developed and Developing Countries (UN Model).

OECD Model

59. **The OECD Model establishes residence as the primary criterion for determining what State must tax** foreign source income earned by a resident. This is the principle by which double taxation would be eliminated. The Model Convention establishes that, as a general rule, income such as international traffic, royalties, capital gains from the alienation of shares, technical assistance, technical services, pensions, and other income can only be taxed in the State where the recipient of the income resides, limiting the possibility of taxing such income to the State where the income originates (the source State). Only in the case of dividends, interest, capital gains derived from the sale of shares representing immovables, real estate income, and proceeds from the sale of real estate is the tax established in the source State. Independent personal services receive the business profits treatment and can only be taxed if they are provided through a permanent establishment. Also, the assumptions for constituting a permanent establishment in a State have limitations.

60. **The OECD Model provides means of dispute resolution and includes mandatory arbitration for authorities.** The first is governed by mandatory minimum standards on MAP to ensure that they are agile, do not prevent access to the means of defense provided for in domestic legislation, and require the contracting states to resolve disputes within specified timeframes, suggested to be two years in the OECD Model commentary. The model also includes tools to combat tax evasion and avoidance, such as information exchange and tax collection assistance.

UN Model

61. **The UN Model establishes the source as the primary criterion for determining what State must tax the income earned by a resident abroad.** This model leans toward protecting the taxing rights of countries where the income is generated, as is the case of royalties, capital gains from the alienation of shares, technical assistance, technical services, international ship traffic, and other income. The UN Model has a regime applicable to independent services under Article 14 and allows for easier constitution of a permanent establishment in the source country.

62. **The definition of royalties is broad,** potentially expanding the tax base in the source country. It includes, for example, payment for the use (or the concession for use) of industrial, commercial, or scientific equipment. The commentary in the Model even clarifies that the use of satellites can be treated as royalties, the opposite of what is established in the OECD Model.

63. **The UN Model has a specific article on income from technical services** that establishes the right to tax at source income obtained by a resident abroad from the provision of such services, as detailed below.

E. Power to Tax Certain Income Under Treaties

64. **The most relevant income from cross-border operations in terms of conventions is** interest, royalties, dividends, capital gains, independent personal services, and technical assistance and services. Business profits and the related concept of permanent establishment are also very important.

Interest (Article 11)⁴³

65. **Both Model Conventions stipulate that the source State can tax interest paid by its residents abroad.** Treaties normally establish this and define the applicable tax rate (or rates). The prevailing logic, especially for developing countries that are capital importers, is that a relatively low rate is preferable in order to avoid making credit more expensive. The cost of the tax is normally absorbed by the debtor country since the international creditor typically has the market power to raise the interest rate by the withholding percentage.

⁴³ The article in parentheses refers to the OECD Model.

66. **The second discussion is whether the withholding rate must be uniform for all types of interest or whether there should be different treatment for different types of interest.** Imposing higher rates on interest paid to entities other than banks or to holders of bonds placed in international markets might follow the reasoning that there is more room to absorb a higher tax in such cases; however, the downside for the tax administration (in terms of how it is to exercise supervision in such cases) probably does not justify this approach. Such methods are even less appropriate for a tax administration with scarce resources.

67. **A very important aspect of the treaty is the definition of interest.** The UN and OECD models have a traditional definition (credit income of any kind) but restrict what is meant by interest income. They leave out a significant number of financial operations, such as financial leasing, factoring, the sale of credits at a discount, income from the alienation of credits, and income from some derivative financial operations, concepts that are, for the most part, included in the definition of interest contained in Article 4, No. 3, paragraph (b), of the Law. Consequently, many states include a provision in treaties establishing that interest income is to be understood as that defined in accordance with their domestic legislation. This is the most appropriate position for a net capital importing country. The recommendation is to confirm the source tax for interest in the treaty, adopt a single withholding rate (not zero), and make reference in the definition of interest to concepts established in domestic legislation.

Royalties (Article 12)

68. **To determine the power to tax royalties, treaties must first define royalties and then identify the place where they are to be taxed,** both of which pose challenges. The definition of royalties in the OECD and UN models is traditional: income derived from the use (or concession for use) of intellectual property protected by laws (trademarks, patents, trade names, and copyrights, among others). There are two positions as to where they should be taxed: (i) only by the State of residence; or (ii) also by the source State, when the payer is a resident of that State or the intellectual property is used in that State.⁴⁴

69. **The UN Model adds the use of industrial, commercial, or scientific equipment under royalties.** This has a broad connotation, as established by the commentary in the Model. It clarifies that a royalty is the payment for the commercial (and not personal) use of a piece of equipment, whatever it may be. This is the case of satellite use, which involves the provision of a service according to the OECD Model because the person who needs their signal to be transmitted cannot manipulate the satellite. Under the UN Model, this constitutes use of commercial, industrial, or scientific equipment because the satellite is being leased for the purpose of such a transmission.

⁴⁴ Article 4, paragraph (c), of the Law follows the criterion of taxing at source when the payer is a resident or when the items for which royalties are paid are used in Guatemala, which should be reflected in the treaties the country enters into in the future.

70. **There are also differences of opinion regarding payment for software use that should be included in the concept of royalties.** The commentary in the OECD Model concludes that software payments are not copyright royalties; rather, they are a transfer of copyright on the economic exploitation of software. However, various countries do not agree with this interpretation, pointing out (in line with their domestic legislation) that payments for software use are also royalties when all the software ownership rights are not transferred, the software is not completely standardized, and the software is adapted in some form to the user.

71. **The OECD Model excludes from the concept of royalties income derived from technical services.** According to this model, technical services must be treated as business profits and can only be taxed if they are provided through a permanent establishment. By contrast, the UN Model includes a specific article (12A) that grants taxing rights to the State from which the payment for technical services originates, as long as these are specialized services. The main argument for incorporating this article is to combat the erosion of the ISR base in developing countries, which face a significant amount of deductions for payments made under this concept. The commentary in the UN Model adds an alternative provision for taxing technical services, limiting it to situations in which the service provider has a physical presence in that State, except when the payments are made to related parties. Many countries in Latin America and Asia follow the UN Model in this regard.

72. **It is recommended that the definition of source in the Guatemalan model treaty maintain the concept of royalties as per the terms established in the legislation.** It should also include payments for the use of industrial, commercial, and scientific equipment, currently taxed as other income under the law. This change would reduce the rate from 25 percent to the rate negotiated in the treaty. If this income is not included in the concept of royalties under the treaty, income from this equipment would fall under the concept of business profits and would only be taxed if attributed to a permanent establishment located in Guatemala. It is also advised for software payments to be taxed as royalties, except in cases where the software was standardized and its commercial use was limited.⁴⁵ Having source rights for technical assistance payments is recommended as well.

Capital Gains (Article 13)

73. **Both the UN and the OECD models provide that the alienation of shares that derive more than 50 percent of their value from immovable property** situated in the State is taxed at source. This is regardless of whether or not the company that issued them is a resident. In the UN Model and in various countries, gains from the direct or indirect alienation of a certain percentage of share ownership issued by a resident company, even if the alienation takes place abroad, are taxed at source. The gains are taxable in the State in which the company issuing the

⁴⁵ Leasing of industrial, commercial, or scientific equipment is not included in the definition and is treated as other income taxed under Article 104, No. 4. As for software, all cases in which software use is granted are taxed, in accordance with Article 4, No. 3, paragraph (c).

shares is a resident. Other countries tax at a reduced withholding rate when any percentage of shares issued by resident entities is alienated.

74. **Much discussion has also occurred on whether countries should also tax the indirect sale of enterprises** when more than 50 percent of the value of foreign company shares is derived from the shares of a resident company of another State, irrespective of the real estate component. Oversight of such alienation is particularly complex, as control and reporting mechanisms are necessary to inform tax authorities that such share transfers have occurred. Making it mandatory for resident companies to inform the tax administration through specific formats can be useful. It is recommended that gains derived from the alienation of shares of resident enterprises be taxed at source under certain conditions, as established in the UN Model, as well as the sale of shares when their value is derived from immovable property in Guatemala. However, to be practicable, this must be clearly set forth in Guatemalan legislation as well.

Dividends (Article 10)

75. **It is common for dividends paid by a company which is a resident of a State to be taxed at source.** The OECD and UN models suggest establishing two applicable withholding rates. One is a reduced rate in cases where a certain share percentage exists (usually 25 percent of the shareholding). In this case, both models add an anti-abuse provision establishing that access to the reduced rate is only granted if the shares were held for 365 days before the dividends were distributed (including the day of their distribution).⁴⁶ The other rate is higher and applies to smaller shareholdings where portfolio investments are situated.

76. **A broad definition of dividends is necessary.** Many states include in their treaties a reference to the definition of dividends from their domestic legislation not only for commercial, but also for tax matters. The objective is to include certain types of income reclassified as such for the purposes of the treaty (and the agreed withholding) when applying anti-abuse rules.⁴⁷ It is also important for the same withholding rules to apply to the distribution of profits from the permanent establishment to its central office.

Business Profits (Article 7)

77. **Treaties assign the power to tax business profits, but do not define the concept.** The Model Conventions indicate that domestic legislation must be consulted to give the concept context. This usually includes commercial, industrial, agricultural, forestry, livestock, and fishery activities. The OECD Model also includes independent services.

78. **Business profits are only taxed in the State of residence, except when they are attributable to a permanent establishment of another State.** The UN Model includes the

⁴⁶ The planning this seeks to prevent is artificial compliance with the shareholding days before the dividend distribution and the lowering of this shareholding once the dividends are distributed.

⁴⁷ These types of rules could not be identified in Guatemalan legislation.

possibility of attributing income to a permanent establishment if its parent company directly engages in the same activities in the State where the said permanent establishment is located (force of attraction rule).

79. **The manner in which the taxable base of a permanent establishment is determined in the OECD and UN models differs.** The OECD allows for the deduction of virtual payments made between the permanent establishment and its parent company for interest, royalties, and services, whereas the UN Model does not. This approach was adopted by the OECD in 2010 (OECD 2010) based on the assumption that the permanent establishment is, for profit (and tax base) attribution purposes between countries, a distinct and separate entity from its parent company and that such payments must have all the corresponding tax effects, such as deductibility. However, this approach was rejected by many countries because they were legally unable to make at-source withholdings for virtual payments. Neither domestic legislation nor existing treaties allow for this.

80. **The LISR does not limit permanent establishment deductions for payments to its parent company.** In the absence of a restriction in treaties, the provisions of domestic legislation would apply. Symmetry would be restored if these virtual payments were subject to withholding. One way of doing this is to adjust the payment by the amount of corresponding withholding if the payment were made between independent parties. However, it is unclear whether the LISR formally permits this adjustment.

81. **The constitution of a permanent establishment in the OECD Model is more difficult than under the UN Model.** There are two essential criteria for constituting a permanent establishment: (i) the existence of a fixed place of business where all or some of the business activities are carried out; and (ii) when dependent agents located in one State enter into contracts on behalf of the resident abroad or when the said agent usually plays the primary role of entering into routinely concluded contracts without substantial modifications by the resident abroad for the transfer of ownership of goods, rights of use, or service delivery. The UN Model includes a third assumption for constituting a permanent establishment when an insurer collects insurance premiums in the territory of a foreign State. Treaties should include these three assumptions.

82. **Under the OECD Model, the permanent establishment as the fixed place of business must prove that it conducts business activities in a geographic location.** This is the case of construction, installation, or assembly works, which must also have a duration of at least 12 months. Under the UN Model, the permanent establishment for the stated activities does not have to prove the existence of a fixed place of business, as it is in itself considered to meet this condition. The duration for constituting it is six months. Guatemala incorporated the UN criterion into the negotiation of the treaty it signed.

83. **According to the OECD Model, independent services follow the same source taxation principles as business profits.** This position is not shared by the UN Committee of

Experts on International Cooperation in Tax Matters. According to this Committee, it is advisable to maintain the option of taxing at source income from independent services based simply on 183 days of physical presence, without the need for a fixed place of business. This position protects the tax base of a net capital importing country and is the one adopted by the LISR and the treaty that was signed by Guatemala.

International Traffic (Article 8)

84. **International traffic has been traditionally taxed exclusively in the State of residence of the company operating the ships or aircraft.** Treaties normally reflect this position. Some countries (Greece and Panama) have a strict policy of preserving taxing rights if ships are registered in their territory. Pursuant to its legislation, Guatemala reserves the right to partially tax income attributable to the source. Signing a treaty under the terms explained would mean a loss of the tax base.⁴⁸

Other Income (Article 21)

85. **Treaties normally include an article on “other income” applicable to a series of relevant items that do not fit under any other articles.** This is the case of income earned for free, such as donations, raffles, or lotteries, as well as income obtained through inheritance or legacies, the application of penal or civil clauses derived from the breach of contracts, the payment of damages, and some derivative financial operations that do not qualify as interest and that are not made in the regular course of business or as part of the corporate purpose of companies. The OECD Model grants exclusive taxing rights to the country of residence for this type of income, whereas the UN Model provides the taxing option to the source State from which the payments originate. Domestic legislation establishes a withholding rate of 25 percent on such payments, which would obviously be negotiated down in a treaty. However, it is important that the payments be subject to withholding.

F. Arbitration (Article 25)

86. **Access to arbitration is compulsory under the OECD Model.** The process would start at the request of the taxpayer if the MAP provided for in the Convention has not been resolved in two years. The UN Model considers arbitration as an alternative, but in a different way. The process would be initiated at the request of any of the tax authorities once three years have elapsed since the initiation of the MAP and grants the authorities of the states involved the possibility of changing the decision of the arbitration panel if they reach an agreement within six months of the issuance of the panel’s resolution. Many developing countries have favored the protection of their sovereignty and have not included compulsory arbitration in their treaties. This is besides the technical training deficiencies they might have in administering such arbitration.

⁴⁸ Articles 21 Bis 104, (a), 1 of the LISR would cease applying.

G. Entitlement to Treaty Benefits (Article 29)

87. **In the recent update of the OECD and UN models, new provisions were incorporated to prevent the misuse of treaties.** These provisions reflect the agreements established in BEPS Action 6 (minimum standard, see Chapter VII), which eliminates treaty benefits when one of the main purposes of the operation is to obtain a tax benefit from the convention. The treaty with Mexico includes a benefit limitation clause that defines the persons residing in the other State who qualify for treaty benefits, excluding those with preferential treaties that are not of general application. This clause would not comply with the minimum standard established in BEPS Action 6 because it does not include a rule against intermediary companies⁴⁹ or a provision on the primary purpose of the operation. This means that the treaty must be renegotiated.

H. Non-Discrimination (Article 24)

88. **Non-discrimination is a principle that treaties contain** by virtue of which differential treatment between residents and non-residents is prohibited in various situations. The two most relevant situations are: (i) where the permanent establishment of a resident abroad must pay taxes under the same conditions as the company which is a resident of the State in which it is formed; and (ii) where the payments made by Guatemalans to residents of the other State must be deductible under the same conditions as would be applicable to residents of Guatemala, except that those payments abroad do not meet market prices. A treaty that includes these principles would result in the limitations on deductions in the legislation not being applicable to payments made to residents of the other contracting State given that international treaties are hierarchically superior to domestic legislation. This would be the case of the non-deduction of interest paid to foreign residents other than financial institutions (LISR, Art. 24) or the deduction limitations established for technical services paid abroad (LISR, Art. 21). A treaty would have this collection cost for Guatemala.

Recommendations

- Ensure that the decision to negotiate a treaty includes a cost-benefit study.
- Do not enter into treaties with countries that do not have income tax because the risk of double taxation, the reason for such treaties, is non-existent.
- When entering into treaties, minimize collection costs—especially with respect to higher withholdings—and do not accept withholding rates of zero.
- Use the UN Model, which favors taxation at source, as an initial reference for building a Guatemalan model treaty.

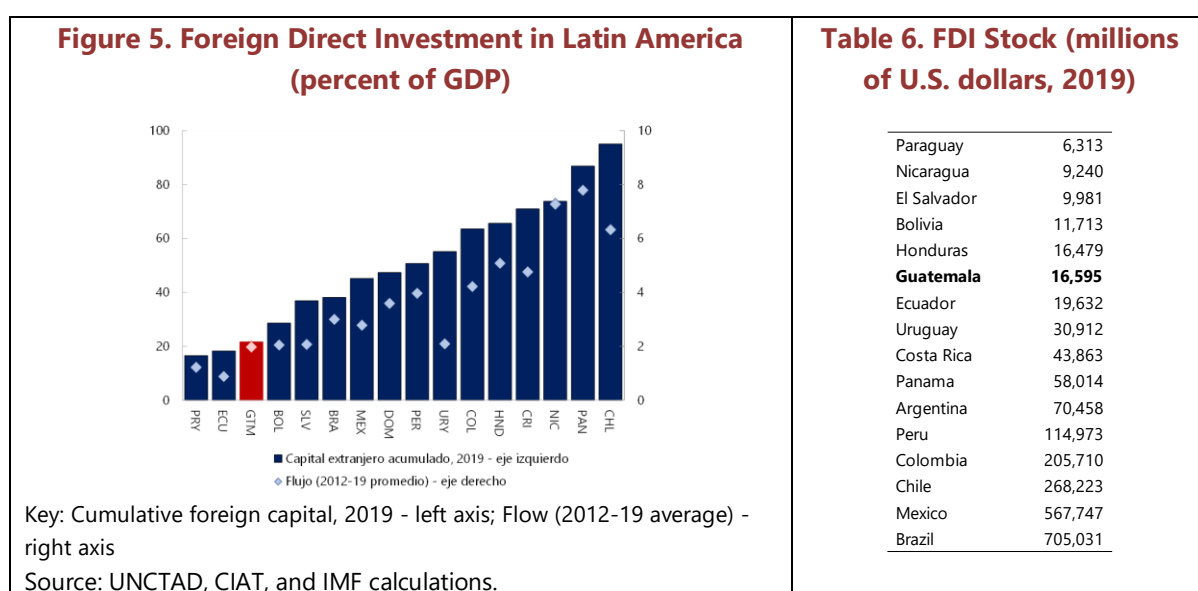
⁴⁹ The rule denies treaty benefits when a resident company forms an enterprise in another country that has a treaty with a third country and the intermediary enterprise receives a payment from the third country in order to transfer it to the company located in the first State, with which the country from which the first payment originates does not have a treaty (or has a more onerous treaty).

- Including at-source tax on royalties
- Agree in the treaty that the terms “interest,” “royalties,” and “dividends” are those defined in the domestic legislation, allowing, for example:
 - Income from financial operations derived from debt to be treated as interest
 - Royalty treatment to be applied to:
 - Income from the use of standardized software
 - Payments for specialized technical services (Art. 12A of the UN Model)
 - The leasing of industrial, commercial, or scientific equipment
- Confirm the at-source taxation of “other income.”
- Incorporate into treaties the permanent establishment cases defined in the legislation, except for preparatory or auxiliary activities.
- Include the “force of attraction” rule for permanent establishments in respect of income obtained by the parent company.
- Incorporate anti-abuse rules into treaties, in accordance with BEPS Actions 6 and 7.
- Do not include compulsory arbitration as a dispute resolution mechanism.
- Consider the treaty with Mexico as a good example of a treaty with a high at-source tax content.

V. TREATIES AND FOREIGN DIRECT INVESTMENT

A. Foreign Direct Investment in Guatemala

89. **FDI flows to Guatemala are modest, including compared to other countries in the region.** In 2019, FDI stock in Guatemala amounted to US\$16.6 billion, equivalent to 20 percent of GDP, well below the regional average (50 percent) and even the average of low-income countries in Latin America (40 percent). FDI flows in recent years have followed the same pattern, representing less than 2 percent of GDP (2012–2019), half of the region’s average and two thirds of the percentage of low-income countries in Latin America.



B. Key FDI Determinants

90. **The extensive economic literature studying the factors that determine FDI flows** finds that tax pressure is a relevant factor, but not the most significant one. Other factors are frequently more prominent in explaining FDI, such as income level, market size, physical and human capital availability, political stability, institutional strength, and tax regime stability.⁵⁰ One factor in particular discussed in the literature is the potential effect of treaties for the avoidance of double taxation (TADT).

⁵⁰ On FDI and the level of economic development, see Eaton and Tamura (1994); Carr et al. (2001); and Bergstrand and Egger (2007); on institutional strength, see Globerman and Shapiro (2002); Aizenman and Spiegel (2002); and Bénassy-Quéré et al. (2007); on corruption levels, see Wei (2000); and on the development of the financial system, see diGiovanni (2005); Head and Ries (2008) find the development of the financial system significant.

C. Double-Taxation Treaties and Foreign Direct Investment

91. **More and more literature has been produced in recent years on the specific impact of TADTs and FDI flows** with the understanding that, in most cases, these treaties have the double effect of providing legal certainty to foreign investors and reducing the tax burden in the host country.⁵¹ This would, in principle, have a positive effect on FDI. The tax policy argument is that these treaties also have collection costs for net capital importing countries, in addition to administration costs, as explained earlier. It is therefore important to know how successful these treaties have been in increasing FDI and offsetting the adverse effect on tax revenue. The answer to this question is an empirical one.

92. **TADTs can directly reduce tax revenue due to concessions on rates and the tax base.** This is particularly significant for developing countries that are net capital importers and normally have a fragile tax collection structure, like Guatemala (see Chapter II). Various studies show that TADTs reduce tax collection in developing countries (Easson 2000; Lewis 2013; ActionAid 2015 and 2016; Hearson and Kangave 2016; Beer and Loepnick 2018; Jansky and Sedivy 2018). However, the cost may be higher through indirect means since treaties, although bilateral by definition, open the door for third-country investors to conduct business through entities residing in the contracting State of the convention (Milchesen and Leduc 2021). Additionally, the proliferation and variety of TADTs have created a set of inconsistent rules allowing multinational enterprises to use opportunistic treaty shopping strategies, that is, intermediate investments through the most profitable treaties (Zucman 2014). For this reason, caution in considering the negotiation of TADTs is commonly advised (IMF 2014).

D. Empirical Evidence

Literature

93. **Early empirical studies found that treaties have a positive effect on FDI, but the results were questioned shortly thereafter.** One of the first studies examined FDI flows to and from the United States for the period 1966–1992 and found that those flows are higher for countries with which a treaty was signed (Blonigen and Davies 2000). However, the same authors reconsider their results in stating that the positive effect was noticeably diluted in the more recent years of their study. The explanation is that the United States entered into its first treaties with advanced countries, whereas in subsequent years, treaties were primarily signed with developing countries, clearly indicating a difference in the impact treaties had depending on the counterparty's level of development. A second study by the same authors, focused on investigating the effect of U.S. TADTs with developing countries, shows that there is no

⁵¹ Works by Hines (1988), Janeba (1996), and Edmiston et al. (2003) show that tax complexity and uncertainty inhibit FDI because transaction and compliance costs rise. Lower effective tax rates have been associated with larger FDI flows in the empirical works of Gordon and Hines (2002) and of Mooij and Ederveen (2003).

significant increase in FDI flows to these economies. However, the study surprisingly finds that TADTs increase FDI flows *to the United States* (Blonigen and Davies 2004).

94. **Later studies generally have unclear or negative results.** Blonigen and Davies (2005) expand and update the sample of countries studied. The authors examine country pairs consisting of not only the United States, but also all OECD member countries and their respective counterparts, both advanced and developing economies, with or without a treaty, for the period 1982–1992. Estimates indicate that treaties between an advanced country and a developing one are irrelevant for FDI and can even have a negative impact. More recent studies also find that TADTs do not affect FDI flows from advanced countries to less developed economies (Baker 2014). In the case of the United States in particular, treaties are found to have a negative effect on FDI flows to those economies (Daniels and Ruhr 2015). Studies that analyze the determinants of FDI stock (instead of flows) tend to find that TADTs have a positive effect (Barthel et al. 2010; Lejour 2014). However, these estimates include FDI that may have occurred before the treaties entered into force.

95. **Changes in the estimation methodology did not yield more conclusive results.** Estimates can sometimes be biased because they do not adequately isolate the effects that other policies or events, simultaneous to the ratification of the treaty, can have on FDI. To isolate this effect, Egger et al. (2006) compares changes in FDI between countries two years before and after the ratification of a TADT and the same changes between countries that did not enter into treaties during those same years. The results again show that the entry into force of new treaties has a negative effect on FDI. A study by Neumayer (2007) suggests that the number of TADTs signed by a country is associated with higher FDI levels, but the effect is not significant for poorer countries. The author notes that developing countries that sign treaties with advanced economies also tend to grant considerable tax incentives, separate from the treaty, which could distort the results.

96. **The institutional aspect is confirmed as a determining factor of FDI.** Based on the income tax returns of U.S. multinational enterprises in the 1990s, Louie and Rousland (2008) examine FDI in foreign subsidiaries based on the TADTs in force and the indicators of corruption, political instability, and bureaucratic inefficiency in the host country. The results show that good governance simultaneously promotes FDI and the conclusion of TADTs, whereas treaties alone have no impact on FDI. This is especially relevant for Guatemala, which ranks very poorly on international indexes regarding the perception of corruption and political stability.⁵²

97. **Regional studies also generally do not establish a connection between TADT and FDI.** Assuming that countries in the same region tend to have similar development levels, institutional characteristics, and governance standards, these variables have a less significant effect in explaining FDI differences and make econometric estimates of the effect of treaties on

⁵² Transparency International, *Corruption Perceptions Index 2020* (129th out of 180 countries); Corporation for Excellence in Justice, *Political Stability and Absence of Violence Index 2020* (147th out of 213 countries).

FDI more “pure.” In Asia’s case, Yue (2018) analyzes FDI flows to 10 ASEAN Group countries, with the results showing that, on average, treaties have a negative effect on FDI flows. Murthy and Bhasin (2015) examine the case of India and conclude that treaties do not have significant effects on FDI flows. Beer and Loeprick (2018) study the effect of TADTs in 41 African economies during the period 1985–2015 and find that treaties with countries that are considered to be financial centers (with low taxation) do not promote FDI, but significantly reduce tax collection in the FDI recipient country.

Some Data for Latin America

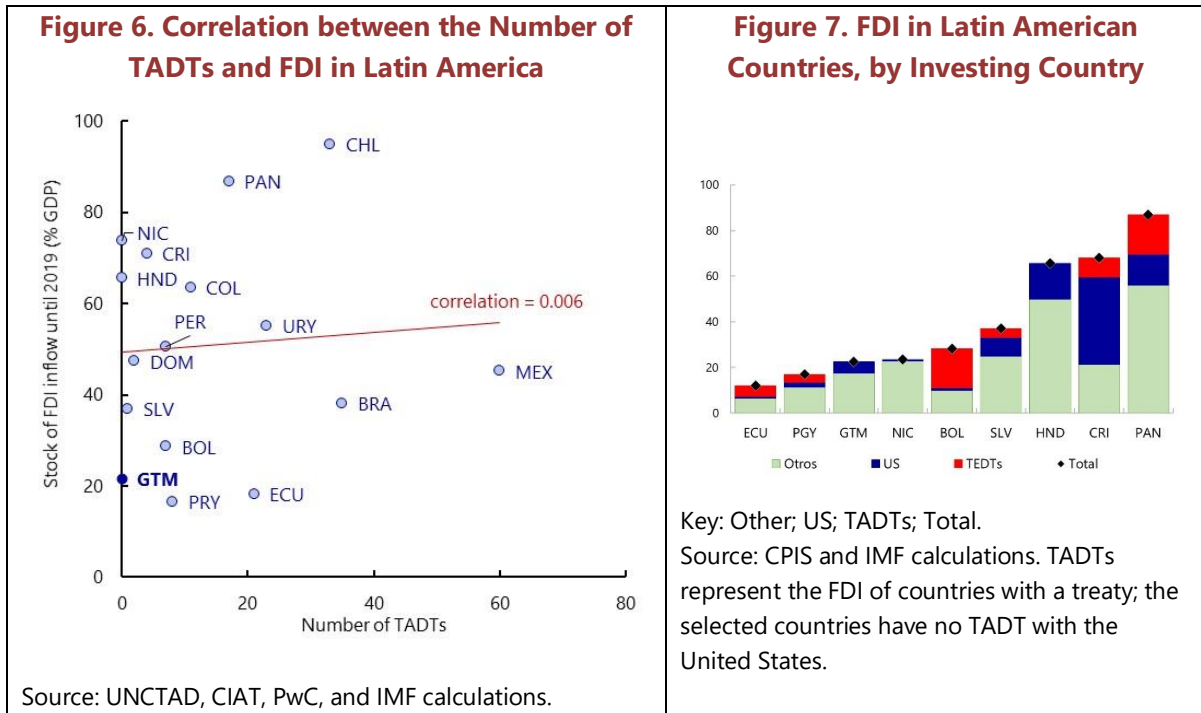
98. **The number of TADTs in force in each Latin American country does not appear to be associated with FDI amounts.** The number of current treaties for this group of countries varies widely, as shown in Table 7. Figure 6 shows the correlation between the number of treaties in the region’s various countries (horizontal axis) and the FDI stock (2019) in each one (vertical axis). The coefficient (measured by the slope of the red line) is very close to zero, suggesting that there is no major relationship between the two. Figure 7 shows that FDI mostly originates from countries without current TADTs (except Bolivia). This is explained in part by the fact that the principal investor in the zone is the United States, whose policy has been reluctant to enter into treaties with Latin American countries.⁵³

Table 7. Number of Treaties for the Avoidance of Double Taxation, 2021

Guatemala	0
Honduras	0
Nicaragua	0
El Salvador	1
Costa Rica	4
Bolivia	7
Peru	7
Paraguay	8
Colombia	11
Panama	17
Argentina	21
Ecuador	21
Uruguay	23
Chile	33
Brazil	35
Mexico	60
Total	467

Source: CIAT.

⁵³ The United States has treaties in force with Mexico, Venezuela, and three Caribbean jurisdictions.



99. **A recent study for Latin America concludes that treaties do not lead to greater FDI in signatory countries.** Shah and Qayyum (2015) study 15 countries in Latin America and the Caribbean between 1983 and 2013. The empirical model includes traditional determinants of FDI flows, such as the size and level of development of the economies, their degree of trade openness, and the level of human capital. The results show that FDI flows to the region's countries are not affected by the number of signed TADTs or the ratification of new treaties.

100. **One argument is that treaty benefits are marginal relative to the tax privileges that countries in the region offer unilaterally.** Like Guatemala, the countries studied generally offer relatively low withholding rates and very generous special regimes. Another explanation is that many Latin American countries have abundant natural resources that attract foreign investment regardless of the tax regime, much less a treaty. Various countries even offer (or offered) foreign investors tax stability agreements.

Recent Studies

101. **More recent studies, with sophisticated statistical techniques, also do not provide conclusive evidence that treaties encourage FDI in developing countries.** The methodologies explore data for individual enterprises or examine the effect of a treaty network. In the case of Swedish multinationals, the data indicate that treaties do not increase the investment of subsidiaries already established abroad (since before the treaty), but do raise the likelihood that new enterprises will enter the host country (Davies et al. 2009). A more in-depth study finds that TADTs can have different effects depending on the economic sector. The hypothesis is that TADTs are less relevant for multinationals that trade in homogenous products for which the transfer price is clearer and the risk of double taxation lower (Blonigen et al. 2014). However,

when a country with a low tax regime (including low withholding rates) stands between two countries with TADTs, FDI flows between these two economies increase considerably, but this would be due to the effect of treaty shopping (Van't Riet and Lejour 2018; Petkova et al. 2020).

102. **In summary**, the empirical literature suggests caution in assuming that entering into a TADT will have considerable effects on FDI. Box 1 supports this caution.

Box 1. Preliminary Estimates of the Effect of the TADT with Mexico

Preliminary estimates have been prepared on the effects that the entry into force of the treaty with Mexico would have on collection and FDI. The estimates are generally positive, projecting a relatively low tax cost in the first three to four years, reversing from that point owing to strong capital inflows from Mexico. However, caution in interpreting the FDI numbers is advised.

In principle, the mission agrees with the assessment that the costs of the treaty with Mexico would be fairly low, although it did not have all the necessary data to verify the estimates on the collection effect. The assessment is founded above all because the treaty does not modify the withholding rates on payments abroad. However, the projected effects on FDI should be reconsidered.

A preliminary study commissioned by FUNDESA estimates that the average annual growth rate of FDI flows from Mexico would increase considerably from 4 to 12 percent just a few years after the treaty's entry into force. The estimate assumes that FDI in Guatemala would grow at rates similar to those observed in three of the region's countries (Panama, Costa Rica, and Uruguay) following the ratification of a treaty with Mexico. These countries also have a territorial tax system.

The first major problem is the selection of data on FDI. The IMF database (used by the study's authors) has two series, one reported by the country of origin of the investment and another reported by the destination country. The series differ substantially.¹ The first is admittedly more incomplete and less reliable (Damgaard and Elkjaer 2017), but is the one used in the study. The FDI trajectory changes noticeably depending on the series used.

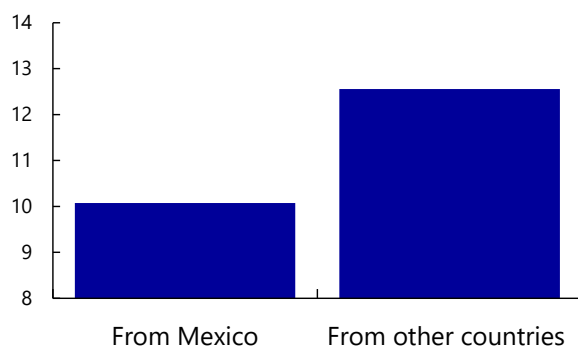
The second problem is the extrapolation for Guatemala because the situation of other countries might not be comparable. In Panama, for example, the expansion of the Canal could have played a much bigger role than the treaty in attracting FDI. In Uruguay, Mexico's FDI prior to the treaty was virtually non-existent, which is why a small investment would have represented a very high, albeit irrelevant, percentage increase.

Moreover, the periods before or after the entry into force of the treaty are not long enough to establish changes in the FDI growth trend. In Costa Rica's case, there is only information for one year *after* the ratification of the treaty, whereas in Panama's case, there are only two years *before* the treaty (which the study extends to three because it considers 2011 as being prior to the treaty, even though it entered into force in January of that year; this study is inconsistent with the criterion used for Costa Rica).

Mexico's FDI in Panama is growing slower relative to the FDI of other countries, despite the treaty. From this perspective, Mexico's treaty with Panama did not have an effect on FDI in the second country (Box 1). Uruguay's data are also not very encouraging when examined closely. The level of Mexican FDI there was actually negative for most of the years after TADT ratification.

In sum, caution is advised in interpreting the results of these studies, which are highly dependent on the methodology used.

Figure Box 1: Average Annual Growth in FDI from Mexico to Panama After TADT (2011-19)



Sources: CDIS and IMF calculations.

¹ The series of Mexican FDI flows to Guatemala from the Bank of Guatemala is negatively correlated with the flows reported by Mexico to the CDIS.

VI. TRANSFER PRICES

A. The Arm's Length Principle

103. **The international practice is to establish in law the obligation for intra-group operations to be agreed at market prices.** The underlying risk is that conglomerate companies, especially transnational ones, will manipulate the value of their internal transactions to shift their profits to an entity subject to a lower tax burden. Both the OECD and the UN have issued detailed guides for determining transfer prices to prevent tax avoidance via this route (OECD 2017a; UN 2017).

104. **The basic principle is established in Guatemala under the Income Tax Law as the principle of "unimpeded competition" (*libre competencia*)** (LISR, Art. 54). In short, it stipulates that, for tax purposes, the price or consideration of transactions between entities from the same group must be determined in the manner that would have been agreed by independent parties under comparable conditions, meaning at market prices. The relevant market in this context is that which matches the conditions in which the taxpayer in question operates and which is not necessarily one of "unimpeded competition." If the taxpayer operates in oligopolistic conditions, for example, the transfer price that complies with the principle is one that independent parties would agree on in this type of market, which in this case is different from a market characterized by unimpeded competition. The translation of the English term "arm's length principle" in Article 54, which follows the language of the Spanish OECD guidelines, is not the most appropriate; this report therefore refers to "*principio de independencia*" in Spanish, which seems like a more suitable translation.

B. Burden of Proof

105. **The principle can operate in two ways, depending on who has the burden of proving that the principle has been met.** The legal framework can empower the tax authority to verify that the taxpayer complies with the arm's length principle and, where applicable, rectify or adjust the taxpayer's tax returns when it finds non-compliance. This is set forth in Article 55 of the LISR, but this wording places the burden of proof with the authority. Another approach is for the law to expressly impose on the taxpayer the obligation to comply with the arm's length principle, empowering the authority to adjust the taxpayer's tax returns if that is not the case. The LISR (Art. 65) requires the taxpayer to meet a documentation requirement demonstrating compliance with the arm's length principle. This is an indirect way of ensuring that the taxpayer complies with that principle, but it is preferable for the obligation to be explicit and for the documentation to be an additional requirement, with its own penalties in case of non-compliance.⁵⁴

⁵⁴ The recommendations in this section refer to amendments to legislation, unless it is expressly stated that the regulatory change can be made in the regulations to the law.

106. **The tax authority should be empowered to adjust the taxable income and deductions declared by the taxpayer according to the arm's length principle.** This is different from the authority being able to determine or directly modify the prices of commercial transactions, as can be interpreted from the LISR (Art. 55). The right to free trade should prevent this. The recommendation is to modify the text of the Law to make it clear that the authority's power is to adjust the ISR base (income less deductions) based on the market prices applicable to related transactions, without altering the prices agreed in contracts entered into under the provisions of common law.

C. Scope of the Transfer Pricing Regime

107. **The obligation to comply with the arm's length principle applies in Guatemala only to transnational related operations** (LISR, Art. 56, A). This combats the higher risk of profits being shifted abroad and ultimately being removed from the domestic tax base. The principle does not apply to transactions between domestic related parties. The main reason is because the profits are shifted through transfer pricing between two national treasury taxpayers. The possibility of tax planning is thus reduced substantially but does not disappear altogether. A company from the domestic group can be a beneficiary of a special tax regime or may have losses that could be leveraged by shifting profits from related companies that are profitable.⁵⁵

108. **Exempting domestic businesses from the arm's length principle opens the door to price manipulation in connection with international related operations.** One example is an exporting company that brings in another domestic company to sell to a related party abroad. The planning is done in two steps: (i) the first company sells at a transfer price below cost, nullifying its ISR base in Guatemala and, although this transaction is not at market price, escaping SAT scrutiny; and (ii) the second company, the official exporter, uses tax planning to reduce its cost (by buying at a low price), which serves as the basis for the "market" profit margin it must apply to comply with the arm's length principle. This artificially reduces the ISR base in Guatemala but meets the transfer price requirements established in the Law.⁵⁶

109. **Some countries establish the obligation to comply with the arm's length principle for transactions between domestic related parties.** This normally entails a high administrative cost for many companies, including small ones, without a major effect on total tax collection. Certain considerations therefore come into play. For example, the burden of proof for domestic related operations can be reverted to the tax authority, exempting companies from the obligation to provide documentation on transfer prices. This facility can be limited only to small

⁵⁵ This can be common given that Guatemala does not allow for loss carryover to be deducted in subsequent fiscal years.

⁵⁶ Tax planning can have two players. First, the biggest "value chain" risks in Guatemala shift to the first company, the one generating losses, meaning that the market profit margin for the second company, a low-risk, low-function distributor, is reduced to a very modest one. Second, the base to which the (already reduced) profit margin (of an independent comparable) is applied is also artificially reduced, and it is not the same to tax a profit of, for example, 5 percent on costs and expenses of 100 as the same percentage on 50 or 20.

companies that pay taxes under a simplified regime, for example, or that have annual sales below a certain amount. Small operations can also be exempted, regardless of the size of the company performing them.⁵⁷

D. Definition and Presumption of Related Parties

110. **The definition of related parties in Guatemala in large part follows the international standard.** Parties are considered related when they have ownership or control linkages with a 25-percent share threshold (LISR, Art. 56). This percentage is relatively high, but likely has no major consequence.⁵⁸

111. **The LISR deviates from the standard in limiting the Treasury’s power to adjust transfer prices only when these mean higher taxation for the taxpayer (Art. 55).** Obviously, the Treasury does not audit taxpayers to correct errors in their favor. The person concerned can correct such errors and request reimbursement of the undue payment. Nevertheless, when it comes to transfer prices, what must be taken into consideration is that the tax authority of the other country, where the operation’s related counterparty resides, can also exercise its power and correct transfer prices in its favor. To avoid double taxation,⁵⁹ in principle, a correlative adjustment should be allowed in the valuation of the related operation in the first country (if it is in line with the arm’s length principle), a situation that must be authorized by its tax authority. In Guatemala, the SAT would be unable to do this without violating the letter of Article 55 of the LISR.⁶⁰ This can be expected to change if a TADT comes into force.

112. **Legislation on transfer prices normally presumes that a commercial counterparty which is a resident in a low-tax territory is a related party.** This means that these operations must comply with all the obligations associated with the arm’s length principle. This is a defensive provision to protect the country’s tax base, especially when jurisdictions that do not fully cooperate in exchanging information are involved. Although the international community has made significant progress in that respect,⁶¹ many countries maintain this type of legal

⁵⁷ In Mexico, companies with sales under MEX\$13 million (and MEX\$3 million for the provision of independent personal services – Art. 76, Section IX, of the Mexican LISR) are not required to document transfer prices. This system is vulnerable to companies deciding to subdivide their operations in order to stay below the exemption threshold. However, this practice can be countered through general anti-abuse rules contained in Guatemala’s domestic legislation (LISR, Art. 61).

⁵⁸ The LISR (Art. 179) defines related parties without establishing a minimum share threshold. The World Trade Organization (Agreement on Custom Valuation) sets a 5-percent threshold, whereas the FDI classification is 10 percent (Mesias 2015).

⁵⁹ This is economic double taxation, where the same income is taxed for two separate persons.

⁶⁰ Article 57 of the LISR, which defines the transfer pricing scope, does not contain this restriction.

⁶¹ The Convention on Mutual Administrative Assistance in Tax Matters backed by the OECD and the Council of Europe, has allowed for the exchange of information at the request of a party since 1988. In 2010, the Convention opened to all countries and currently has 144 signatories. More recently, a new standard was developed for the automatic exchange of information through the Global Forum on Transparency and Exchange of Information for

presumption. Guatemala does not have one.⁶²

113. **This measure can be implemented in various ways.** First, it must be defined as a low-tax jurisdiction. This can be done based on the ISR rate of the statutory tax regime of the foreign country (or a percentage difference with respect to the rate of the general regime in force in Guatemala) or the effective rate that the company in question pays in that country. The first method is simpler, but may not capture the company's real tax burden. The second is more precise, but also more complex because a comparison of effective tax rates requires a recalculation of the foreign entity's ISR in accordance with the accounting standard and Guatemala's ISR regime. Some countries simply opt for listing the countries they consider to be low-tax (and uncooperative), even though this strategy also has its limitations.⁶³ In principle, the presumption could admit proof to the contrary, that is, documentation on the effective beneficiaries of the resident entity abroad showing the lack of relationship with the resident entity.

114. **In Guatemala's case, the simpler parameter is preferable.** For example, a threshold could be defined for the statutory rate of a territory below which it would qualify as low-income.⁶⁴ One challenge in applying this presumption in Guatemala is if the taxpayer is subject to the simplified optional ISR regime because this might sometimes represent a very low effective rate on profits, whereupon the exercise loses relevance. Defining another jurisdiction as low-tax makes sense as long as it is a qualification relative to the regime itself. In any case, those subject to this optional regime also have incentives to manipulate transfer prices since their sales to related parties comprise the tax base in Guatemala. While the residence of a counterparty offers more favorable tax conditions, there will be an incentive to shift profits by undervaluing exports.

115. **The combination of rules on the presumption of relationship, documentation, and deduction requirements is an important tool against profit shifting to tax havens.** Multinational enterprises often use tax havens with zero taxation in which to locate subsidiaries that market commodities produced in developing countries. This triangulation is designed to leave a wide profit margin in the intermediary's country, reducing the tax base of the producing company by the same extent. Insofar as the exchange of information is difficult, the multinational enterprise can report the transaction as being between independent parties such that the

Tax Purposes. Guatemala signed this Convention in 2012 (in force since 2017), but is classified as "non-compliant."

⁶² Article 56.B.1 of the LISR presumes that a resident and their exclusive agent or distributor abroad are related parties. This excludes the (most common) case of when the foreign company is the regional or global distributor of a set of the group's subsidiaries.

⁶³ The list must be updated daily and runs the risk of always lagging behind and therefore being incomplete. The country in turn may be subject to diplomatic pressure.

⁶⁴ For example, if the statutory rate is lower than the rate that would represent 60 or 50 percent of Guatemala's general ISR regime rate on profits from lucrative activities.

producing country's Treasury cannot question the (reduced) income from foreign sales. Therefore, the possibility of presuming that they are related parties is important in order to empower the Treasury to adjust transfer prices in the event of non-compliance with the arm's length principle. Furthermore, the Treasury can also determine which of the parties taking part in the transaction is the tested party, that is, the one required to demonstrate that, according to the transfer pricing method selected, its profit margin is comparable to a company with similar functions.⁶⁵ This would require the multinational enterprise to disclose its operations in the tax haven, which, if lesser as is normally the suspicion, would be remunerated accordingly, reverting the tax base to the producing country. In the event of a refusal to provide the corresponding documentation and its inaccessibility to the tax authority through country-by-country reporting as per BEPS Action 14 (see Chapter VI),⁶⁶ legislation can include a provision stating that documentation on transfer prices is a requirement for the deduction of payments to related non-residents.

E. Methods

116. **The LISR includes the five methods for assessing transfer prices contained in the applicable international guides.**⁶⁷ The LISR (Art. 59, 2) also establishes precedence when more than one method is applicable. It favors the first three methods, that is, the "traditional" ones (comparable uncontrolled price, cost plus, and resale price), that OECD guides also formerly favored. This changed in 2010 when the OECD's approach shifted to the use of the *most appropriate* method based on the circumstances of the case. The argument is that one method is not better than another in the abstract, but one is more appropriate than another depending on the facts. The two additional methods, based on a profit indicator (transactional profit split and transactional net margin), have remained hierarchically equal to the traditional methods since then. This approach is more flexible, but also allows multinational enterprises to use the most efficient method for reducing the tax base as their first option.

117. **Guatemala could keep a method hierarchy that favors only the "comparable uncontrolled price" method** limited to commodities. This is a more direct method that works more efficiently with homogeneous products whose price formation is transparent in international markets that generate public information, such as the Chicago Mercantile Exchange, London Metal Exchange, or Intercontinental Coffee Exchange.

⁶⁵ Normally, the party subject to this test is that which conducts the simplest activities, with fewer functions or assets, as is generally the case with commercial intermediaries; see OECD (2017a), paras. 3.18 and 3.19.

⁶⁶ Guatemala does not receive *country-by-country reports* since it is not a member of the Inclusive Framework.

⁶⁷ The five methods are: comparable uncontrolled price, cost plus, resale price, transactional profit split, and transactional net margin. The methods are sufficiently explained in the (OECD and UN) guides themselves and in the Platform for Collaboration on Tax (2017), with a special focus on their application in developing countries. Some countries mention the OECD guides in their laws as a source of interpretation of their legislation on transfer prices. This can be appropriate for OECD member countries, which Guatemala is not. Guatemala also does not participate in the Inclusive Framework supported by the OECD.

118. **A triangulation risk is thus avoided.** It is common for the multinational enterprise to establish an intermediary in a low-tax jurisdiction that buys at a low price from the subsidiary in the producing country and resells at market price to the end customer, keeping a significant profit margin from the operation. One argument is that the intermediary performs sophisticated and risky trading (which is difficult to verify) and that the producing subsidiary is a routine, low-risk business because the financial arrangements with the multinational enterprise ensure stable and predetermined performance, such that the residual profit (the economic income of the business) is captured by the intermediary outside the country. These arrangements often have no substance and are valued using the transactional net margin method. Recording the aforementioned hierarchy of methods for commodities in the LISR does not mean designing a special or different method for them, as it seems Guatemala has done by introducing a sixth exclusive method for imports and exports, discussed below.⁶⁸

119. **The BEPS Action 10 report states that this method is generally adequate for commodities** (OECD 2015e).⁶⁹ This suggests that such a method hierarchy may be useful, but as long as the valuation mechanics reflect the logic of the arm's length principle, that is, that comparability between the reference market transaction and the related transaction is favored and, where applicable, the necessary adjustments are permitted to achieve comparability (OECD 2015e, p. 51).

F. Rules for Specific Transactions

Commodities

120. **The LISR (Art. 60) establishes a special valuation method for goods imports and exports that is (seemingly) mandatory.**⁷⁰ Although it is understood that the standard could have been introduced to regulate the (bound) commodity trade price only,⁷¹ it applies strictly to all (intra-group) foreign trade in goods, overemphasizing its scope. It would have been thus even if it had been limited to commodities because not all are listed on an organized stock exchange or are significant in Guatemala's trade.⁷²

⁶⁸ Mexico, for instance, gives the comparable uncontrolled price method priority for all goods (LISRM, Art. 180). Other Latin American countries, such as Argentina, Uruguay, and Ecuador, have been stricter (albeit with variations) by imposing a specific reference price to value some commodity transactions. Argentina's version, from which the name "sixth method" originates, has been criticized by those who support the traditional approach of the arm's length principle. See, for example, Ariel Efraim (2013), "Argentina and the so-called 'sixth method,'" *BDO Transfer Pricing News*, No. 16.

⁶⁹ The content of this report was reflected in the OECD transfer pricing guidelines (2017a).

⁷⁰ The letter of the law leaves little doubt that the method is compulsory for goods imports and exports. In practice, taxpayers and the authority understand that it is an additional, optional method.

⁷¹ Commodity exports, which typically account for a high percentage of the total exports of low-income countries, are particularly vulnerable to transfer price manipulation.

⁷² In 2021, three commodities (banana, coffee, and cardamom) accounted for 17 percent of total exports in Guatemala (source: Bank of Guatemala).

121. **The method is confusing.** It imposes a maximum price on imports in line with an undefined “international parameter” and establishes that the price of exports must be calculated according to an “international price investigation,” which is not explained. This article of the Law contains no decipherable method because it cannot be inferred how the price that taxpayers must agree to in order to comply with the law is determined.

122. **The regulation contains some details on how to apply this transfer pricing method,⁷³ but these seem insufficient to provide legal certainty.** It states that, for exports, the reference price can be a “known listing on the international market” or “on stock exchanges.” These concepts could be explained in greater detail, providing examples for Guatemala’s top commodities (banana, coffee).

123. **The special method under Article 60 outlines the two anti-abuse measures.** The first refers to transactions between related intermediaries for an independent party that only serves as a cover for the non-resident related party (a back-to-back type of operation) to make it seem like the transactions are between independent parties, free from transfer pricing obligations. The second refers to the listing date of the good, which should serve as a reference.⁷⁴

124. **Both anti-abuse measures should be reviewed.** A problem with the first rule (Art. 60, fourth paragraph) is that it affects every independent intermediary, without differentiating the tax regime of the territory in which the intermediary resides, as long as it does not have a substantial activity or activities there independent of the business with the Guatemalan exporter. Countries generally protect their taxpayers’ tax base, assuming that the non-resident counterparty is related when the tax regime that applies to it is one of low or zero taxation and the jurisdiction is not fully cooperative in disclosing the effective beneficiary of the said counterparty. These are easier conditions to verify compared to determining whether the third parties with which the intermediary transacts are related parties of the first exporter or identifying the substantial activity carried out by the intermediary. Another problem, by no means minor, is that the provision leaves out of its scope all related intermediaries that triangulate from tax havens operations with independent third parties, which can be a much more common situation.

125. **The price of commodities listed on global markets fluctuates from day to day,** which is why the precise date on which the operation is agreed is important for determining the price of a transaction.⁷⁵ This can potentially be manipulated between related parties. Some countries have adopted a strict rule to avoid this: the reference price that must be considered is that which is listed on the market the day the good is shipped. Article 60 allows for some flexibility in this rule, since it admits a different quoted price if “...it is proven that the operation was closed on

⁷³ Government Agreement 213 – 2013, Art. 53 and 54.

⁷⁴ “...will be considered as market value: 1. In the case of goods with a known international listing on the international market, stock exchanges...the said list value on the last day of the shipment...” (Government Agreement 213 – 2013, Art. 54).

⁷⁵ The reference price can also be the average or a range during a given period.

another date.” The problem is whether the contract alone is proof of the date on which the price was agreed. The regulation provides this clarification: the price in the contract may be considered when it is presented, notarized, to the SAT not more than three business days after the date (Government Agreement 213 – 2013, Art. 54). The OECD approach allows for the imposition of the quoted price on the shipment date when there is no evidence of the date on which the price was agreed (BEPS Action 8–10, p. 54).

126. **The authority’s approach could be clearer and simpler.** First, it could make the comparable uncontrolled price method compulsory for some commodities only (banana, coffee, and fuel, for example) and eliminate the special method for goods exports and imports. Second, it could introduce in the standard the types of permitted comparability adjustments, which should reflect the price formation practices in the export or import market. To define the permitted adjustments, following the practices of each market, it may be worthwhile to form technical working groups with representatives of exporter associations, especially independent traders and brokers.

Interest

127. **Multinational enterprises often inflate interest payments abroad to shift profits to another destination, normally low-tax territories.** Two mechanisms can be used: (i) rates that are higher than market rates; or (ii) the over-indebtedness of the company subject to tax planning. For this reason, many countries have developed special rules to prevent abuse, besides transfer pricing instruments.⁷⁶ BEPS Action 4 agreed on a common strategy to combat the problem, recommending that countries adopt in their domestic legislations a limit on the deduction of interest (earnings stripping rule) of up to 30 percent of the company profits (EBITDA).⁷⁷ This measure would simultaneously attack the different paths to reducing the tax base through debt instruments and would replace separate strategies focused on limiting rates and the amount of debt.⁷⁸ This is a better protection mechanism than the different instruments the LISR provides in Guatemala.

128. **Guatemala has various special rules for limiting the deduction of interest** (LISR, Art. 24). Its first “thin cap” rule limits interest deductions for any debt that is three times higher than the value of the taxpayer’s assets. The rule applies to all of the taxpayer’s debt, whether or not it is with a related party. The restriction is broad, but steers clear of circumventing the

⁷⁶ The application of the arm’s length principle to control profit shifting through debt instruments is particularly complex because multinational enterprises are free to establish the contractual conditions in pursuit of a desired tax outcome. For example, an internal loan between group subsidiaries can be arranged without a guarantee, whose comparable in the market attracts a high rate of interest, but this results in an artificial arrangement since the debt is with itself. See the Chevron Australia (2107) case: [Chevron case: ATO wins landmark transfer pricing case - The Tax Institute](#).

⁷⁷ See OECD (2015b).

⁷⁸ Countries traditionally tackled this problem by regulating the interest rate through transfer pricing rules and the debt amount through thin cap rules.

provision via loans backed by a related party (back-to-back). International practice varies. For example, in some countries, the rule considers only long-term debt, while in others, it considers only debt with related parties. The rule in Guatemala is also particular because the debt-to-equity ratio basis is “net asset,” in principle, which in practice would allow for debt to be up to one time the asset amount.⁷⁹ The rule does not permit carryover of interest that is not deducted during the fiscal year. Various countries have abandoned this thin cap system in favor of an earnings stripping rule or have substantially reduced the initial debt-to-equity ratio from 3 to 1, like Guatemala has today (Canada, for instance, reduced it from 1.5 to 1).

129. **The legislation also limits the maximum deductible interest rate** (LISR, Art. 24, second paragraph). This measure complements the thin cap regime, which only heads off planning by means of the excess debt amount. The limit applies to all debt operations, including between independent parties, and is equal to “the maximum annual simple rate determined by the Monetary Board for tax purposes.” The rule is excessive because it applies to market operations. For the purpose of related operations, although the rule is straightforward, it is also potentially arbitrary because it does not necessarily represent market conditions. The rule can also be lenient because the punitive (default) interest for debts with the Treasury is normally considerably higher than the interest for comparable (normal) financing operations between independent parties.

130. **Another restriction in Guatemala is that interest payments abroad are deductible only if the creditor is a bank or a financial institution** regulated in the country of residence. All interest on loans contracted with companies residing outside the country, whether or not they are related, is therefore non-deductible. This is unusual. Countries typically allow for inter-company interest deductions and impose a tax withholding on the payment. A highly restrictive policy in this regard can affect FDI, which is typically financed in part with debt contracted with the investor group.⁸⁰ It is also true that debt between related companies is, to a certain extent, an invention (lending to itself) that grants tax advantages with respect to the contribution of capital and the payment of dividends, which are not deductible.⁸¹

131. **In short, the arm’s length principle is a weak system for controlling tax planning through intra-group debt.** The international consensus is that anti-abuse rules must be introduced, but the ones Guatemala has in its LISR are not adequate. It would be preferable to replace them all with just one that simultaneously controls the abuse of rates and

⁷⁹ The definition of net asset in the LISR nevertheless seems to differ because it refers to the “book value of all assets owned by the taxpayer” (LISR, Art. 24, fourth paragraph).

⁸⁰ In 2019, around 12 percent of FDI originating from Latin America was financed through debt. For Guatemala, this component represented just 5 percent; see ECLAC (2021).

⁸¹ Attempts to define debt versus equity for tax purposes had already been declared a failure in the 1980s in the United States; see Bulow et al. (1990). Difficulties in differentiating one concept from the other continue to this day.

over-indebtedness (earnings stripping rule), limiting the total interest deduction amount to 30 percent of EBITDA, as recommended in the BEPS Action 4 report.

Royalties

132. **One of the main concerns in BEPS works was the manipulation of transfer prices in relation to intangible operations.** The valuation of intangible assets (intellectual property) is particularly complex because these are usually unique assets without comparables in the market. It is even more difficult to value them when they are transferred before their development process is complete, as is often the case inside a multinational group. Expectations of success in this case can be very speculative and difficult for the Treasury to verify. It is especially difficult to value an isolated intangible asset relative to the rest of the knowledge accumulated by the company with which intellectual property in particular can be developed. These issues enabled high-tech companies to shift many of their intangible assets to low-tax countries through intra-group transactions agreed at notoriously undervalued prices.⁸² Income (royalties) from the use of these assets then flowed to those low-tax countries. However, this is a problem faced mainly by developed countries.

133. **Developing countries also create some intangible assets,** but normally find themselves on the other side of the operation, as those paying the royalties. Intangible assets developed in countries such as Guatemala are typically national brands or other elements associated with a product that set it apart and give it a competitive advantage in the market (for example, relationship with clients). On occasion, the local subsidiary may invest its own resources in the development of a foreign brand, meaning that, for transfer pricing purposes, it would have “economic ownership” over the intangible asset, with a partial entitlement to benefits from its use, despite not being the legal owner of the intangible asset. In accordance with the new OECD guides on this topic (OECD 2015e; OECD 2018), the benefits of using an intangible asset must not rest solely with the legal owner, but rather be distributed between the group’s entities that contributed to the development, enhancement, maintenance, protection, and exploitation (DEMPE) of that intangible asset.

134. **Contributions to the development of an intangible asset registered abroad can be reflected, for example, in a lower royalty rate** that a subsidiary in Guatemala must pay to its parent company. This also means that if, for example, a multinational enterprise registers an intangible asset in Guatemala and intends to use a tax advantage without Guatemala having made an economic contribution to its development or administration, the other countries where the intangible asset’s DEMPE is verified may require income to be reallocated according to their

⁸² Intellectual property was also relocated through cost-sharing agreements, by way of which the multinational enterprise financed the development of the intangible asset from a subsidiary residing in a low-tax country, whereupon the subsidiary also shared ownership and usufruct of the intangible asset (generally the right of use in a geographical area).

respective contribution, denying Guatemala the intended tax base (and the multinational enterprise the intended tax planning).

135. **A frequent situation in developing countries is the intra-group disposal of national brands.** It is common for domestic capital companies with traditional brands in the domestic market to be acquired by multinational enterprises and for their brands to be sold to a subsidiary abroad. From that point forward, the resident company will pay royalties abroad, thereby reducing the tax base in the country of origin. Irrespective of the asymmetry that this operation represents in Guatemala due to the fact that capital gains are taxed at 10 percent (LISR, Art. 92) and profits at 25 percent (general regime), tax planning occurs if the brand selling price is lower than its market value at the same time as royalties are at market value. To prevent this type of planning, additional rules can be considered, such as favoring the financial valuation method that requires the net present value of the flow of royalties generated by the intangible asset to match the value in which the intangible asset was transferred.⁸³

136. **The restriction on royalty deductions is fairly lax (LISR, Art. 21, No. 25).** The standard imposes a deduction limit for this of up to 5 percent of the taxpayer's gross income, without restricting the generation of this income to royalty payments. This means that the royalty deduction can fully eliminate the tax base for businesses that earn up to 20 percent profit from sales, without considering DEMPE aspects and the possible domestic origin of the intangible asset as well as the price at which it was transferred abroad. It is therefore recommended to strengthen the standard with limitations that consider these factors.

Services

137. **Intra-group services are typically subject to particular scrutiny by tax authorities.** From a logistical standpoint, they are a fairly straightforward way of shifting profits. The OECD transfer pricing guides therefore include special rules for valuating these types of transactions. First, it must be demonstrated that the service was actually provided. In addition, it must be proven that the service is a benefit for the acquiring entity and that, if the entity were independent, it would be willing to pay for it. Proving the above requires more than an invoice on the part of the service provider. Services that are not remunerable, for example, are those provided by the parent company to its shareholders. Once these conditions are met, the logic of the arm's length principle applies like to any other related operation. Article 62 of the LISR imposes the charge (or price) directly on the personalized service, as would be done by independent parties.

138. **The application of the arm's length principle is hindered mainly when the service received cannot be personalized.** When the functions of an entity are supposed to be for the benefit or support of the group as a whole, without personalizing a particular service, the OECD

⁸³ Some countries have stricter measures, such as not permitting deductions for royalties paid abroad if the intangible asset was originally developed in the country.

guides accept the use of an “indirect-charge” method. This means that the operator’s costs can be apportioned among the group’s other entities based on the extent to which they benefit from its services. This method is supposed to be valid only in exceptional cases. Article 62 of the LISR authorizes it as long as the total consideration is distributed among the beneficiaries according to reasonable distribution rules (a concept that remains undefined). Given the difficulties traditionally encountered in verifying the expenses incurred abroad by a non-resident entity and, particularly, in establishing that these expenses were applicable to the resident subsidiary, some countries introduced rules preventing deduction of such apportioned expenses in the country.⁸⁴ It is particularly important in this case to apply the profit test as a defensive measure.

139. **OECD works on BEPS offer a mechanism for simplifying compliance with the arm’s length principle in connection with some services.** The possibility of implementing a safe harbor for low value-added services was introduced in transfer pricing guides⁸⁵ so that such services could be considered valued according to this principle if the stated profit margin on costs and expenses did not exceed 5 percent. This simplification seems reasonable in principle, but, in the case of non-personalized services, expenses incurred abroad may end up being deductible in the country without a clear benefit for the domestic taxpayer. Introducing this option is not recommended for now.

G. Documentation

140. **The taxpayer must document compliance with the arm’s length principle.** This is established in Article 65 of the LISR, but has been subject to an OECD minimum standard (BEPS Action 13) since 2017.⁸⁶ The standard requires large multinational enterprises (with global sales above EUR 750 million) to provide the authority with three types of documents, namely a local file showing that the taxpayer’s related operations comply with the arm’s length principle, a master file explaining the global operations of the multinational enterprise, and a country-by-country report providing certain accounting details about its worldwide operations country by country. This latter report is a new component of the standard now available to all tax administrations where the multinational enterprise operates (see Chapter VII on BEPS minimum standards). Guatemalan legislation only mentions the first document. The country-by-country information could be very useful for the SAT in analyzing the risk of tax evasion by multinational enterprises operating in the country, information that, without the minimum standard, multinational enterprises did not normally agree to share with authorities other than that of the country of residence of their parent company.

141. **Besides the technical study on transfer prices, the taxpayer must provide an annex to the annual affidavit containing details on transactions with related parties abroad.**

⁸⁴ Mexico had this rule in its LISR until 2014, when it was declared unconstitutional by the judicial authority.

⁸⁵ Such services must not be the company’s primary business, support the business, or use valuable intangible assets.

⁸⁶ OECD (2015f).

However, this annex does not include information on the counterparty's country of residence, information that could be very useful in conducting risk analyses and guiding auditors, with a focus on transactions with low-tax countries. The affidavit must also include the amount of debt contracted with third parties and within the group, specifying the residence of the debt issuer.

Recommendations

- Introduce an explicit requirement in the law for the taxpayer to comply with the arm's length principle, clearly placing the burden of proof on the taxpayer.
- Replace the tax authority's power to adjust the prices of related operations with the power to adjust taxable income and deductions according to market prices.
- Eliminate the condition whereby the SAT can adjust transfer prices only if this increases the tax, while permitting the authorization of correlative adjustments that have the opposite effect.
- Extend the obligation to comply with the arm's length principle to related operations between resident companies, but with the burden of proof resting with the authority.
- Alternatively consider ensuring that the option of not documenting compliance with transfer pricing (burden of proof) is limited to small businesses and to transactions below a certain value, specified in the regulation.
- Presume that operations with low- or no-tax jurisdictions are with related parties.
- Define low- or no-tax jurisdictions for transfer pricing purposes as those tax jurisdictions whose statutory ISR rate represents 60 percent or less of Guatemala's general statutory rate.
- Specify that the party residing in the low-tax jurisdiction is the tested party.
- Do not allow the deduction of payments to low-tax jurisdictions unless the taxpayer provides documentation to comply with transfer pricing obligations.
- Introduce higher hierarchy only for the comparable uncontrolled price method and only for commodities listed on a global organized market.
- Eliminate the compulsory special method for imports and exports.
- Permit the use of any other method aside from the five listed, as long as its results comply with the arm's length principle.
- Reformulate anti-abuse measures regarding intermediation for exports:
 - Assume that the independent counterparty participates in the back-to-back operation when it resides in a low-tax jurisdiction.
 - Assume that it is a related party when it resides in that jurisdiction, even when intermediating with independent clients.
- Specify that the quoted price of the commodity will be that in effect on the shipment date in the absence of evidence that it was agreed on a different date.

- Replace the thin cap rule with a maximum interest deduction as a percentage of EBITDA (30 percent).
- Eliminate the deductible interest rate limit as determined by the Monetary Board for tax purposes and establish that the deductible rate is that which is determined by transfer prices, as long as the deduction does not exceed 30 percent of EBITDA.
- Limit the royalty deduction so that the net present value of the payment flow is consistent with the value at which the intangible asset was alienated, as applicable.
- Include in the standard the DEMPE components carried out by the parties in order to determine the consideration for the use or exploitation of an intangible property of a subsidiary.
- Do not include a safe harbor to comply with the arm's length principle in transactions involving low value-added services.
- As a condition for deducting payment for related services, introduce the profit test in the law stating that the service must be a taxpayer benefit and that, if the taxpayer were independent, it would be willing to pay for it.
- Reformulate the transfer pricing annex to the annual affidavit so that it includes information on the country of residence of the related counterparty and the amount of debt with related parties (in addition to the interest paid).

VII. BEPS MINIMUM STANDARDS AND RECENT AGREEMENTS ON THE INTERNATIONAL TAX ARCHITECTURE

A. Introduction

142. **The international tax system inherited from the beginning of the last century proved to have major loopholes** that made it possible for multinational enterprises to avoid taxes on a large scale by concentrating their income in low-tax jurisdictions (OECD 2013a; IMF 2014). The weaknesses in the concept of source and the arm's length principle—pillars of this system—that allowed multinational enterprises to shift profits and erode the corporate ISR base (BEPS) eventually made it clear that the system needed to be repaired. The G20 therefore endorsed an action plan agreed within the OECD in September 2013 containing 15 specific actions to curb BEPS (OECD 2013b). Four of these actions or measures are compulsory for countries party to the agreement. These are the BEPS minimum standards. The other actions, although not compulsory, were introduced in the OECD guidelines or were recommended as best practices toward which countries should converge. A large number of countries have adopted them since then, as they have proven to be valuable tools in protecting the domestic tax base.

143. **A large part of the analytical work on BEPS was completed in 2015**, and reports were published with specific recommendations for each of the 15 actions. To broaden the community of countries participating in the adoption of the recommended measures and in the discussion on pending issues, especially regarding the digital economy and the international tax system, the OECD backed the creation of the Inclusive Framework, a group of countries open to all those interested. Participation is under conditions equal to those of OECD or G20 members, with voice and vote on pending issues related to BEPS, but also entails the obligation to adopt minimum standards and consent to prior agreements on BEPS (OECD 2017b).

144. **At present, 140 countries belong to the OECD Inclusive Framework; Guatemala is not a member.** This means that the country is kept out of discussions and decision-making on international taxation, while also being exempt from the obligation to adopt the BEPS minimum standards. In principle, this is a counterproductive position because the BEPS measures are designed to protect countries' tax base. Otherwise, that is to say, where a country is a BEPS beneficiary that promotes harmful tax competition, that country is exposed not only to being identified as such, but also to potentially facing defensive measures from the rest of the countries (higher withholding rates, for example). Isolation in the tax community does not seem to be a sustainable position in the long run. This is even more true with the agreements reached under the Inclusive Framework in October 2021 adding additional measures to the international tax architecture, the so-called Pillar 1 and Pillar 2, as explained below (OECD 2020a; OECD 2020b).

145. **Adopting the OECD minimum standards involves implementing four specific actions from the BEPS package, which would require Guatemala to join the Inclusive Framework.** These are as follows: Action 5, eliminating harmful special regimes and transparency; Action 6, introducing anti-abuse measures in treaties; Action 13, country-by-country reporting on multinational enterprises; and Action 14, introducing the mutual agreement clause in TADTs and facilitating the procedure in practice. These measures entail changes to domestic legislation, especially treaties. Since Guatemala does not have treaties in force and is not the country of residence of the parent companies of large multinational enterprises for the purposes of Action 14, only Action 5 could have substantial consequences in the short term if the OECD minimum standards were to be adopted. The minimum standards are analyzed in the next section, with particular attention on Action 5 regarding special regimes and transparency. The second section of this chapter briefly discusses the new agreed changes to the international tax architecture (known as Pillars 1 and 2).

B. Action 5: Combating Harmful Tax Practices

146. **A key concern of the OECD BEPS plan is combating aggressive tax planning by multinational enterprises,** which take advantage of loopholes in the international tax regime to artificially shift their income to low-tax jurisdictions. Action 5 of the BEPS plan (OECD 2015c) addresses the concern for two particular situations that may be harmful:

- Tax regimes that offer advantageous conditions for companies conducting high transnational mobility activities and that are an incentive for artificial profit shifting;
- Special tax treaties granted through confidential tax rulings.

147. **The purpose of Action 5 is to establish rules for eliminating abusive tax practices encouraged by unfair tax competition between countries, which ultimately ends up being negative for the set of countries.**⁸⁷ This does not mean eliminating preferential tax regimes, but rather creating conditions that will prevent them from being an incentive to engage in harmful tax practices. The two key concepts used to distinguish harmful regimes are: (i) substantial activity, where the company benefiting from a preferential tax regime has a substantial economic activity in the country granting preferential treatment; and (ii) transparency, where the preferential tax regimes granted to companies, even those contained in tax rulings, are known to other tax administrations.

148. **Action 5 is subject to a review by the Forum on Harmful Tax Practices (FHTP).** This peer review examines whether current regimes comply with these two aspects of the minimum standard, that is, that they are not harmful and that they are transparent, both in the design of

⁸⁷ Some analysts argue that tax competition between countries is healthy to a certain point and promotes efficiency with states providing their services. In other words, it would help keep the tax burden closer to optimal levels because governments would have a natural tendency to tax and spend more; see, for example, P. Kehoe (1989).

the rules and in their practical application.⁸⁸ When the regime is not compliant, it is called “non-compliant” or “largely non-compliant.” In that case, the country must commit to eliminating the regime or modifying it so that it stops being harmful (or ultimately expose itself to defensive measures taken by the community of countries). Although Guatemala is not a member of the Inclusive Framework, it can also be subject to review by the FHTP if a member country reports that it is a “relevant” jurisdiction for the Forum’s work (OECD 2019, p. 11).

149. **The Action 5 report establishes the criterion for determining cases in which a tax regime should be considered preferential and potentially harmful.**⁸⁹ Special tax regimes can be harmful based on five key factors:⁹⁰

- Reduced or no effective tax on geographically mobile activities or services
- Access to the regime only for residents abroad (ring-fencing)
- Lack of transparency regarding regime conditions
- Lack of an effective exchange of information in relation to the regime and its beneficiaries
- The regime does not require substantial activity in the territory

150. **The main concern under Action 5 is that these regimes can benefit “geographically mobile” activities, such as service or financial businesses.** In other words, the tax benefit is available for activities that can be formally shifted from one territory to another at a low cost and that do not need an extensive business structure to operate. The mere registration of the legal ownership of an intangible asset would also qualify as such.

151. **The risk is that an entity from a multinational group with little physical presence in a country will record disproportionate income there.** This would violate the basic principle of the current international tax system where income is reported (and taxes are paid) in a manner aligned with the business activities of those who generate that income. Therefore, to rule out the harmful effects of a regime, the “nexus” condition must be met, which requires substantial economic activity in the territory in which the multinational enterprise reports its income, such

⁸⁸ The FHTP has reviewed close to 300 special regimes in more than 70 countries. A good number of them have been abolished or modified. OECD (2022).

⁸⁹ The criterion stems from the OECD (1988).

⁹⁰ Five other factors would also help determine whether a tax regime is harmful: (i) an artificial definition of the tax base; (ii) failure to adhere to international transfer pricing principles; (iii) foreign source income exempt from residence country tax; (iv) negotiable tax rate or tax base; and (v) existence of secrecy provisions. The concept is applicable to a preferential regime for a group of taxpayers or to the general regime of a territory, where it charges low or no tax and has any of the additional features.

that the tax bases cannot be artificially shifted from countries where the value is created to other countries with lower tax pressure.⁹¹

152. **The tax benefits for manufacturing activities would normally not be referred to as harmful.** These activities involve moving fixed assets and production capacity from one country to another, meaning that they would not normally qualify as geographically mobile activities. These activities would by definition meet the condition of substantial activity. In sum, the OECD does not intend for countries to abandon their preferential regimes, but rather to apply them only when entities conduct a substantial economic activity in the territory in question that justifies the income they report there.

Box 2. Preferential Regimes That Could Be Harmful

- *Headquarters regimes.* The main activity is the managerial control or coordination of a group of resident enterprises in different countries. The substance test must indicate key actions in the generation of income and in decision-making on the management of expenses and investments on behalf of the rest of the group's entities. This is a particularly complex test to oversee.
- *Distribution regimes* for group enterprises. The activity could also be the centralized distribution of finished products to end customers.
- *Service center regimes* for other group enterprises or the provision of support and administrative services. The substance test in these cases must consider the existence of product transportation and storage activities and the management of stocks and orders.
- *Financing or leasing regimes.* The substantial activity must demonstrate that the following are carried out in the territory: the negotiation of financing terms, the identification and acquisition of assets to be financed, the determination of financing terms, agreement monitoring and review, and risk management.

153. **Another concern under BEPS Action 5 is that countries grant tax benefits to taxpayers individually in a confidential manner.** This usually occurs through the issuance of a tax ruling that has the force of law, despite being applicable only to the benefited taxpayer (or group of taxpayers). The lack of transparency in granting such benefits is considered to be a harmful tax practice that will have to be eliminated in accordance with the minimum standard established by the BEPS Action. This would be eliminated through the spontaneous exchange of information on relevant tax rulings. These rulings include the following:

- Advance pricing arrangements (APAs), which establish what criteria should be applied to the arm's length principle to value related transactions that a taxpayer performs during a period of time.

⁹¹ One type of harmful preferential regime to which the BEPS report draws special attention is related to intellectual property (such as patents or software; brands, however, cannot benefit from such preferential regimes). This regime imposes a low tax rate on income generated from the use of an intangible asset registered in the jurisdiction in which the owner resides, without that asset having been developed in the territory. To verify the nexus in this case, the taxpayer's expenses for the development and administration of these intellectual property assets must be identified. In the absence of significant expenses, the registration is opportunistic for the sole purpose of taking advantage of the tax benefit (called "patent boxes").

- Rulings on permanent establishments, that is, if the activities of a non-resident in the country meet (or do not meet) the assumptions for consideration as a permanent establishment.

154. **As explained in Chapter II, Guatemala has various significant preferential regimes.** These include the free-trade zone, free zone, and maquiladora regimes. All grant a full ISR exemption for 10 years, among other tax benefits.⁹² Most of the beneficiaries are commercial companies or manufacturers operating with employees, assets, and inventories, thus fulfilling the condition of substantial activity and the nexus principle. However, the regulation enables the benefits to cover a wide range of services,⁹³ which are not always strictly defined, and the control and monitoring mechanisms deployed by the authorities, although improved, are still deficient. This can be problematic.

155. **Guatemala's SAT is empowered to issue both types of rulings that, under Action 5, should be subject to exchange with other administrations.** In both cases, these rulings are confidential and binding on the authority, which the SAT should make known through the spontaneous exchange of information with the authorities in the place of residence of the related parties with which the taxpaying entity in Guatemala transacts.⁹⁴ If it fails to meet this standard set forth in Action 5, Guatemala could be subject to defensive measures taken by the community of countries (OECD 2015c). One way of meeting it, however, is to make the rulings public.

C. BEPS Minimum Standards and Treaties (Actions 6 and 14)⁹⁵

Prevention of Treaty Abuse (Action 6)

156. **BEPS Action 6 is designed to prevent certain types of abuse of TADTs** (OECD 2015d). The benefits granted by a bilateral treaty can be (unduly) extended to residents of third countries through investments that they make in one of the contracting countries. Such investments are typically located in low-tax countries, especially as concerns withholdings on payments abroad, for the express purpose of brokering flows to the ultimate beneficiary, an entity or person residing in another country without a treaty.

157. **A large number of countries traditionally protected their network of treaties with anti-abuse clauses.** They did not always do this, however, and many others, especially developing countries, did not take the precaution of doing so to ensure that the ultimate beneficiary of the payment that originated from and was sourced in one of the contracting

⁹² Decree 22 – 73 (ZOLIC), Art. 32; Decree 29 – 89 (Maquila), Art. 12bis(d); Decree 65 – 89, Art. 22(b). Companies are suspected of renewing the exemption by changing their business name when the first exemption period expires.

⁹³ Only the free-trade zone decree prohibits financial services; Decree 65 – 89, Art. 41(aa); see footnote 11.

⁹⁴ In 2015, Action 5 made it a requirement to exchange rulings issued from 2010 onwards that were in force in 2014. Something similar can be expected if the rule were to be applied to Guatemala, that is, having to share rulings in force that were issued up to five years before the country agreed to apply the measure.

⁹⁵ This topic was already discussed to some extent in Chapter IV on treaties. However, this chapter is presented such that it can be read in isolation from the rest of the report.

countries was actually a resident of the other contracting country. The BEPS minimum standard allows the gap in existing treaties to be filled. The origin of FDI is an indicator of intermediation and a sign of caution. In a low-tax territory with large FDI inflows and outflows representing a very high proportion of domestic GDP (e.g., Cyprus, Luxembourg, Holland, or Switzerland), the risk is that the investment may actually originate from another country and the treaty is being misused.⁹⁶

The Minimum Standard

158. **The BEPS report recommends that countries use a three-pronged strategy to combat treaty abuse.** This recommendation draws on the countries' best practices and includes:

- The inclusion of text in the preamble of treaties stating that the intention of the contracting countries is to prevent tax avoidance or evasion opportunities;
- The use of the limitation on benefits (LOB) test to ensure that treaty privileges are limited only to residents of the contracting countries that meet certain requirements; and
- The use of the principal purpose test (PPT), which denies treaty benefits if one of the principal purposes of the investor's trade arrangement is to obtain the said benefits (OECD 2015d, p. 18, para. 19).

159. **The PPT and LOB methods have their strengths and weaknesses.** The main advantage of the LOB is that it provides greater certainty and is easier to administer. This method entails a specific criterion for determining whether the taxpayer qualifies for treaty benefits, such as the taxpayer's legal nature and the activities the taxpayer carries out in the other contracting State. The weakness of this approach is that it does not anticipate all types of treaty abuse schemes. The PPT, meanwhile, examines the purpose of a business arrangement, whose interpretation is largely discretionary. This means that there is greater flexibility, but also the risk of inconsistencies in the analysis of various countries. By the same token, a transnational trade arrangement could pass one test and fail the other (Herzfeld 2016).

160. **The LOB has various advantages over the PPT in terms of simplicity and administration.** The burden of proof rests with the authority in the case of the PPT. With the LOB, the tax authority only needs information from the payor of the dividends, interest, or royalties to determine whether the non-resident qualifies as a treaty beneficiary. The authority should then be able to confirm the information directly with the competent authority of the other country. The LOB is generally more appropriate for developing countries with few administrative resources.

⁹⁶ Treaty abuse can include round-tripping, when the country's residents register a business abroad to make investments from there in their own country and thus obtain the treaty benefits as if though they were residents of the other contracting State; see Balabushko et al. (2019).

Better Dispute Resolution Effectiveness (Action 14)

Mutual Agreement Procedure

161. **Treaties normally contain a clause on the mutual agreement procedure to resolve differences in the interpretation of the treaty.** The problem that arises in these procedures is that, in practice, it takes a long time to resolve them. The BEPS project planned to solve the uncertainty that these lengthy procedures cause. The measures recommended in the BEPS report promote expeditious resolutions so that the procedure is effective (OECD 2015g).

162. **The minimum standard requires countries to include Article 25(1)–(3) of the OECD Model in their treaties.** This article offers a mechanism for the competent authorities of the contracting countries to resolve differences in the interpretation or application of the same treaty. The main objective of the procedure is to ensure that taxpayers entitled to treaty benefits are not taxed under terms that differ from those set forth in the treaty. This minimum standard is reviewed by panels comprising representatives of authorities from other countries that are members of the Inclusive Framework (peer reviews).⁹⁷

Arbitration

163. **Action 14 also proposes compulsory arbitration as an option for expeditious dispute resolution.** However, there is no consensus among OECD and G20 countries as to the use of arbitration as a dispute resolution mechanism between contracting states as concerns double taxation.⁹⁸ Although arbitration may be very beneficial for countries in which proceedings have remained unresolved for a long time, other countries have had some success in resolving them relatively quickly. For a country without experience, such as Guatemala, arguments can be made for either. For now, there are no problems to resolve, but once the first challenging cases arise, the country's lack of experience can weigh against it and investors will demand arbitration.

164. **Some analysts have reservations about the use of compulsory arbitration because it can be a limitation on the scope of national sovereignty.**⁹⁹ Arbitral rulings are also confidential and do not set a legal precedent, which is why they do not necessarily provide legal certainty to the resolution system. One option is to allow SAT staff to gain experience and take training first by negotiating mutual agreements with counterparties and to defer the adoption of an arbitration clause until future treaties. This minimum standard would require the SAT unit in charge of international taxation to be strengthened.

⁹⁷ Examples of aspects measured during the reviews include the number of MAPs submitted, resolved, rejected, and pending resolution as well as the required resolution time. Country reports resulting from these reviews are published by the OECD.

⁹⁸ Tax Certainty, IMF/OECD Report for the G20 Finance Ministers, March 2017, p. 57.

⁹⁹ BEPS Monitoring Group, Explanation and Analysis of the Multilateral Convention to Implement Tax Treaty.

D. Transfer Pricing Documentation: Country-by-Country Reporting (Action 13)

Who and What

165. **The new documentation requirements for multinational enterprises to report some of their accounting figures country by country are instrumental in the BEPS project** (OECD 2015f). By participating in the project, Guatemala would receive worldwide information from multinationals operating in the country with global sales of more than EUR 750 million annually, which would have to collect and exchange similar information from multinationals whose parent company resides in the country (probably none that meet the threshold). The information exchanged would be in country-by-country (CbC) format and would include details such as income, earnings before taxes, income tax payable and paid, number of employees, declared capital, retained earnings, and tangible assets.

166. **The model legislation drafted to this end requires the parent company of the multinational enterprise to provide CbC information in the jurisdiction in which it resides.** Countries participating in this arrangement have developed a package of measures to automatically exchange information from CbC reports.¹⁰⁰ Their implementation entails meeting confidentiality requirements.¹⁰¹

Surrogate Parent Company

167. **Under the rules, the parent company of the multinational enterprise can designate another group entity, which is a resident in another country, as that which is responsible for submitting CbC documentation on behalf of the global company.**¹⁰² This option prevents the multinational enterprise from having to provide information in multiple countries if the parent company resides in a country that does not require this documentation. The “surrogate parent entity” is a group entity appointed by the parent company as the sole surrogate for CbC reporting purposes.

Implementation and Monitoring

168. **Countries must legislate to require their taxpayers to provide the authority with a CbC report if they are the parent company of a global operation with sales greater than the established threshold.** This must be legislated even when there are no taxpayers in the jurisdiction that meet that condition. Moreover, countries must sign the Multilateral Competent Authority Agreement on the Exchange of Country-by-Country Reports requiring them to

¹⁰⁰ Ibid., p. 23.

¹⁰¹ Ibid., p. 23, para. 60. Guatemala will have to undergo a review by the OECD to ensure that the reporting systems used by the tax authority meet the confidentiality requirements.

¹⁰² Ibid., p. 39.

exchange the information obtained with other tax authorities. Inclusive Framework countries are subject to an annual peer review to verify the correct implementation of the standard. The review covers three main areas: regulations and administrative systems through which CbC obligations are put into practice, the mechanics of exchanging CbC reports, and report confidentiality and appropriate use.

E. New Changes to the International Tax System

169. **The Inclusive Framework coordinated by the OECD has identified serious challenges due to the digitalization of the global economy past the BEPS project.** To overcome those challenges, this community of countries has agreed to introduce new international taxation rules based on two fundamental pillars, namely Pillar 1 and Pillar 2. A timeline has also been established for adopting this strategy between 2023 and 2024.

170. **The international tax system reform contained in Pillar 1 would redistribute a portion of the tax base for income earned by multinational enterprises.** In general, this pillar will expand taxing rights to jurisdictions with a market presence, even if dealt with remotely, instead of attributing that right solely to jurisdictions of residence or source according to traditional international tax principles. Although the initial concern of Pillar 1 were automated digital services and remote consumer-oriented businesses, the scope of the new system has been expanded to include most businesses, excluding some financial institutions and extractive companies. The new regime will apply to companies of a certain global size.

171. **Pillar 2 is focused more directly on tax competition in the broader sense, putting a floor on the IRS rate that countries could allow their taxpayers.** Irrespective of the challenges and pressures caused by many factors leading to the erosion of the tax base and profit shifting, Pillar 2 would ensure that multinational enterprises with income above EUR 750 million pay at least a minimum level of tax, most importantly, in each of the countries in which they operate, even when the domestic regime does not impose them.

Pillar 1

172. **The objective of Pillar 1 is to assign some of the income earned by large multinational enterprises to jurisdictions where they have a significant market presence.** The target are multinational enterprises with global turnover greater than EUR 20 billion annually and profitability above 10 percent. The agreement is for the first threshold to be reduced to EUR 10 billion eight years after the entry into force of the regime. For now, in its initial phase, Pillar 1 is estimated to affect around 100 international companies,¹⁰³ a large number of them in the high-tech sector. The reallocation of the ISR base is also projected to benefit mainly high-income countries where the largest markets are located. In any case, developing countries

¹⁰³ OECD/G20 Base Erosion and Profit Shifting Project, Addressing the tax challenges arising from the digitalisation of the economy, July 2021; p. 14; in [Highlights brochure: Addressing the tax challenges arising from the digitalisation of the economy, July 2021 \(oecd.org\)](#).

could see their tax base expanded insofar as they are also the final destination market for remote digital services, which are not currently subject to ISR.

173. **Pillar 1 establishes three types of income (amounts) that can be reallocated for taxation in market jurisdictions:**

- **Amount A:** This is the amount of operating profit that would be allocated to market jurisdictions, even if the multinational enterprise has no physical presence. This exercise therefore introduces a new assumption on granting a country taxing power that differs from the traditional concepts of residence and source. A jurisdiction is eligible (qualified) to receive an allocation of Amount A if the multinational enterprise earns income there above US\$1 million. This threshold is reduced to EUR 250,000 for jurisdictions whose GDP is below EUR 40 billion. Amount A subject to redistribution between all group entities (and countries in which it operates) will be 25 percent of the multinational enterprise's global "residual" profits, that is, profits exceeding 10 percent of income. Amount A allocated to each country will be determined in accordance with a formula (still under discussion) likely based largely on the value of sales in each jurisdiction.
- **Amount B:** This is remuneration to the qualified market jurisdiction for marketing and distribution by multinational enterprises in that jurisdiction. In some cases, Amount B would provide remuneration to distributors (subsidiaries or permanent establishments) when dealers purchase merchandise from related parties for resale. How Amount A and B allocations will interact has not been finalized yet. This allocation (as well as from Amount C) will follow current transfer pricing rules under the traditional principles of source according to physical presence.
- **Amount C:** Discussions to define Pillar 1 acknowledged the possibility of windfall profits (those additional to routine profits) for marketing and distribution activities carried out in a qualified market jurisdiction. These additional profits are identified as amounts that would arise in the context of dispute resolution between the jurisdiction of residence of a multinational enterprise and a qualified market jurisdiction.

174. **The implementation of Pillar 1 will require changes to domestic legislation and international treaties.** A multilateral agreement (MLA) is proposed for such changes to simultaneously implement Amount A in treaties and avoid countless bilateral negotiations. This involves introducing new rules for the identification of qualified market jurisdictions, eliminating double taxation with respect to Amount A, and facilitating the exchange of information, thus coordinating the resolution of disputes related to Pillar 1. The MLA would require signatory jurisdictions to eliminate all income taxes (on gross income or equivalent) on digital services and similar unilateral measures (which is not the case for Guatemala). Failing this (and if no commitment is made to adopt this type of tax in the future), the multinational enterprises would be outside the scope of Amount A in the country in question.

Pillar 2

175. **Generally speaking, Pillar 2 establishes a global minimum tax threshold of 15 percent, applicable to multinational enterprises with consolidated income above EUR 750 million** (according to consolidated financial statements). The global minimum tax rules (Global Anti-Base Erosion Proposal – GLoBE) would also provide a *de minimis* exclusion in jurisdictions where the multinational enterprise has income of less than EUR 10 million and profits of less than a million.

176. **The new global minimum tax standard would be implemented under three types of rules. The following list shows the order in which they would apply:**

(i) *Subject to tax rule (STTR)*: would allow developing countries (World Bank definition) to eliminate benefits granted under a treaty (reduction of withholding rates) to non-residents if they tax income paid to their residents at a rate below 9 percent.

(ii) *Income inclusion rule (IIR)*: allows the jurisdiction of residence of the parent entity of the multinational enterprise to impose an additional tax on the income of a constituent entity (subsidiary or permanent establishment) when they are subject to an effective ISR rate below 15 percent in the country in which they operate. This additional tax applies in the fiscal year in which the profit is generated, regardless of when it is repatriated to the parent company. Moreover, the tax would follow the individual country-by-country rate and not be based on the rate the multinational enterprise pays on average.

(iii) *Undertaxed payments rule (UTPR)*: would make it possible to deny deductions in a jurisdiction in which resides a constituent entity of a multinational enterprise that makes a payment to another subject to low taxes (less than the minimum), provided that its parent company (or intermediate holding company) does not charge an additional tax (top-up tax) under the IIR because the jurisdiction of the parent company (or intermediate holding company) has not adopted Pillar 2 in its legislation.

177. **The GLoBE rules provide an exception.** Subsidiary profits representing up to 10 percent of the payroll and 8 percent of the tangible assets of the subsidiaries are excluded from the minimum tax base. These percentages will be reduced annually to a margin of 5 percent for both in ten years. This exclusion follows the idea of protecting the flexibility of the tax policy (up to a limit) in countries that host investments representing substantial economic activity, demonstrated for purposes of this rule by the use of tangible assets and the employee payroll. Taxes on income in excess of those margins (and taxed at a rate below 15 percent) interact as follows: the jurisdiction of the parent company would collect first (IIR), followed by the jurisdiction that hosts the related entities with which it does business if the country were to waive

its claim to the difference between the minimum and the current tax in the entity of the affected subsidiary (UTPR).¹⁰⁴

Effects on Guatemala of the Entry into Force of Pillar 2

178. **The implementation of Pillar 2 in Inclusive Framework countries can have an impact on Guatemala.** If the subsidiaries of the multinational enterprise with income above EUR 750 million do not pay 15 percent effective ISR, the difference would be collected by the jurisdictions in which the parent company resides or, in second place, the countries in which the group's other subsidiaries reside if they had regional control over the subsidiary in Guatemala. In other words, if Guatemala does not charge multinational enterprises 15 percent ISR, other countries will for income generated (and declared) in the country.¹⁰⁵

179. **In principle, this reduces the advantages of Guatemalan free-trade zones and other tax incentives designed to attract investment from multinational enterprises with income above EUR 750 million.** These advantages would be reduced or even eliminated if the country where the parent company resides had to pay that difference. This would affect not only companies benefiting from exemptions, but possibly also companies opting for the simplified optional regime. The FDI promotion strategy used by Guatemala would therefore have to be rethought. However, as explained, the global minimum tax applies from a certain profit margin onward. If the profit margin declared by foreign investors in Guatemala is usually less than 5 percent on payroll and tangible assets, the rule will not affect it. It will also not affect international investors whose global income is below EUR 750 million.¹⁰⁶

Recommendations

- Participate in the Inclusive Framework.
- Adopt BEPS minimum standards.
- Consider establishing a minimum tax of 15 percent on activities affected, where applicable, by the implementation of Pillar 2 agreed under the Inclusive Framework.

¹⁰⁴ The right to charge tax based on the UTPR would require coordinating the different authorities of the countries that host subsidiaries of the company subject to the minimum tax, which would be achieved through an allocation formula according to the proportion of assets and personnel employed in each country. This rule continues to be under discussion as part of the Inclusive Framework.

¹⁰⁵ If Guatemala establishes a "differential tax" between the tax charged and the 15-percent minimum tax, the IIR and UTPR will not be applicable.

¹⁰⁶ There is no record for Guatemala in the aggregated database of country-by-country reports for 2017 (last available). See: https://qdd.oecd.org/subject.aspx?Subject=CBCR_REQ. The database has some limitations, as explained at: [Important disclaimer regarding the limitations of the Country-by-Country report statistics \(oecd.org\)](#).

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