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Title:

"FINANCIAL DERIVATIVES AND HEDGING OPERATIONS: COLOMBIAN TAX TREATMENT (ISSUES AND OPTIONS)"

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Abstract

Exposure to market risks arising from the cycle of business activities has been a persistent issue for Colombian taxpayers. As a result, corporations are prone to subscribe and execute hedging operations through derivative instruments in order to mitigate such risks.

However, from a Colombian tax perspective, current regulations do not provide for an appropriate tax treatment on financial derivatives nor hedging operations. The purpose of this dissertation is to analyze the applicable tax regime on these instruments for Corporate Income Tax purposes and explore options to mitigate the legal uncertainty affecting taxpayers involved in these types of operations. Finally, this paper proposes some reforms on the applicable regulations.

Key words: Derivative instruments, Hedging operations, Colombian-source income.

Resumen

La exposición a los riesgos de mercado derivados del ciclo de las actividades empresariales ha sido un problema persistente para los contribuyentes colombianos. En consecuencia, las empresas son proclives a suscribir y ejecutar operaciones de cobertura a través de instrumentos derivados para mitigar dichos riesgos.

Sin embargo, desde la perspectiva tributaria colombiana, la normativa vigente no prevé un tratamiento fiscal adecuado para estos instrumentos ni para las operaciones de cobertura. El objetivo de esta tesis es analizar el régimen fiscal aplicable a estos instrumentos en el Impuesto sobre la Renta y explorar opciones para mitigar la inseguridad jurídica que afecta a los contribuyentes que realizan este tipo de operaciones. Finalmente, este trabajo propone algunas reformas sobre la normativa aplicable.

Palabras Clave: Instrumentos derivados, Operaciones de cobertura, Ingreso de fuente nacional

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Introduction

A derivative is a financial instrument[1] valued on the basis of an underlying asset's price, such as a stock or a commodity, or even of an underlying financial index like an interest rate (Jarrow & Chatterjea, 2013). They are most commonly used by corporations as part of *hedging* operations which ultimately allow businesses to reduce their exposure to risk by providing a form of insurance (Durbin, 2010); this type of instruments are traded through Over-the-counter-OTC[2] markets or exchange markets[3]. A recent statistical release by the Bank for International Settlements shows that the gross market value for OTC derivatives reaches the amount of USD $15.5 Trillion during the first half of 2020[4] confirming how popular is the use of derivatives instruments in the global economy.

According to Bodnar, Hart, & Marston, corporations are likely to undewrite derivative instruments in order to reduce risks and exposure in the course of their regular business activites. Although for several years regulators and academics have tried to provide a comprehensive tax treatment for derivative instruments, these instruments lack a thorough and coherent tax regulation at a global scale, as regulations in force are either too complex, ineffective or ambiguous, resulting in uncertainty on the correct tax treatment at a local or cross-border level for some taxpayers while others engage in complex tax avoidance strategies (Raskolnikov, 2012).

[1] A financial instrument is an agreement that bestows financial rights and/or responsibilities to the parties involved (Durbin, 2010).
[2] An OTC is understood as a market where companies agree directly the terms and conditions of derivative transactions without involving an exchange. (Hull J. C., 2017)
[3] "*The exchange provides market makers, who act as sellers for those who wish to buy and buyers for those who wish to sell. It provides this feature, known as liquidity, by establishing and enforcing strict definitions for derivatives tradable on the exchange. So a buyer or seller gives up the ability to customize a deal, but in return, neither of them must worry about finding a counterparty."* (Durbin, 2010)
[4] Bank for International Settlements Statistical Release: OTC derivatives statistics at end-june 2020: Retrieved from: https://www.bis.org/publ/otc_hy2011.pdf

As a result, the purpose of this study is to identify whether Colombian tax regulations provide a coherent tax treatment on the execution of derivative instrument and hedging operations at a local and cross-border level and, if not, to propose some reforms that may provide and improve legal certainty to taxpayers.

CHAPTER I- Understanding Derivative Instruments

1. Derivative instruments

1.1 Overview of Derivative Instruments

A thorough understanding of Derivative instruments is required to correctly explore the possible tax implications that may arise from the execution of such operations, as well as the issues faced by lawmakers and judges when trying to find solutions and/or provide clarifications about the applicable treatment.

From an economic perspective, derivatives[5] can be understood as instruments or transactions through which additional value is generated or derived from the value of an *underlying asset*[6] (Stulz, 2004) associated with financial variables such as share indexes, interest rates, stock market indexes, commodity prices, amongst others (Rubinstein, 2005). Essentially, it is an agreement which allows the reallocation of risks[7].

In Colombia Executive Decree 2555 of 2010 has defined financial derivative instruments as an operation whose main feature is that the fair exchange price depends on one or more underlying asset or variable while compliance or settlement is made at a future time. Such settlement may be in cash, financial instruments or tradable products or goods, as established in the contract or in the corresponding regulations of a securities trading system[8].

[5] The International Swaps and Derivatives Association (ISDA) has the following definition: A derivative is a risk transfer agreement, the value of which is derived from the value of an underlying asset.
[6] *The variables underlying derivatives are most commonly prices or other features of securities or other assets, which are collectively called underlying assets*- Rubinstein, M. (2005). *Rubinstein on derivatives*. London. Risk Books.
[7] Norman M Feder, 'Deconstructing Over-The-Counter Derivatives' (2002) Columbia Business Law Review
[8] Numeral 1 Article 2.35.1.1.1 of Executive Decree 2555 of 2010.

Similarly, the Colombian Superintendence of Finance through External Instructive (*Circular*) No.041 of 2015 has defined a financial derivative instrument as a transaction whose main characteristic is that its fair value depends on one or more underlying assets and compliance or liquidation is carried out at a future date[9].

1.2 Objective of Derivative Instruments

Furthermore, derivative contracts or agreements are executed, in order to pursue one of the following objectives: ***(i)*** Hedging; ***(ii)*** Speculation or ***(iii)*** Arbitrage [Speculative and Arbitrage instruments will only be generally described, as they are not the primary focus of this study].

1.2.1 Hedging Transactions

One of the main reasons for the execution of derivative instrument between economic agents is the transfer of risks associated with the fluctuations on the value of an asset. Balmer notes that to hedge is to protect oneself from risk, risk being any potential negative variation in value. Thus, from a practical standpoint a hedging operation can be understood as a mechanism through which one of the parties involved wishes to offset or neutralize an existing exposure to certain risks (Fletcher, 2014). In other words, the purpose of a hedging operation is to protect the economic agent from undesired fluctuations in the price of the underlying asset, considering that fluctuations could generate equity losses for the economic agent.

[9] Capitulo XVIII- INSTRUMENTOS FINANCIEROS DERIVADOS Y PRODUCTOS ESTRUCTURADOS. 2.10. Instrumento financiero derivado: *"Es una operación cuya principal característica consiste en que su valor razonable depende de uno o más subyacentes y su cumplimiento o liquidación se realiza en un momento posterior. Dicha liquidación puede ser en efectivo, en instrumentos financieros o en productos o bienes transables, según se establezca en el contrato o en el correspondiente reglamento del sistema de negociación de valores, del sistema de registro de operaciones sobre valores o del sistema de compensación y liquidación de valores."*

In Colombia, the Superintendence of Finance through means of External Instructive No. 041 of 2015 has defined hedging operations as: *"operations with the purposes of hedging a primary position of eventual losses caused by adverse movement of market that may affect the underlying asset, liability or contingency. The trading of this type of instruments seeks to limit or control one or more of the financial risks generated by the primary position being hedged".* Nevertheless, there is no definition in Colombian tax laws or regulations of hedging operations, generating a legal vacuum with complex issues in the determination of the applicable tax regime.

Other countries such as the United States [10] have issued specific regulations about hedging transactions for tax purposes. The US, for instance, defines them as transactions executed in the normal course of a taxpayer's business with the purposes of managing the risks arising from price changes or currency fluctuations regarding "ordinary property" held by the taxpayer. In addition, these transactions also imply the management of risks arising from price changes, currency fluctuations and interest rate changes in connection with the credit operations executed by the taxpayer (Keinan, 2016).

1.2.2 Speculative transactions

Speculative transactions through derivative instruments may allow investors to obtain profits from taking over risky positions in anticipation of price fluctuations (Partnoy, 1997). In other words, speculators seek profits from exploiting opportunities in connection with expected future price changes or mistaken credit assessment in market values [11].

[10] United States of America-Electronic Code of Federal Regulations 26 CFR § 1.1221-2 - Hedging transactions.
[11] Balmer, A. G. (2018). Regulating Financial Derivatives: Clearing and Central Counterparties.

1.2.3 Arbitrage transactions

Finally, arbitrage transactions allow agents to capture riskless economic advantages from the volatility in financial markets arising from *gaps* left by the unavailability of certain financial instruments in given markets and locations (Partnoy, 1997).

1.3 Type of Derivative Instruments

In general terms, Derivatives are generally handled through one of the following financial instruments: (1) Swaps (2) Futures and Forwards (3) Options (Castrillón, Casas, & Parra, 2017):

1.3.1 Swaps

A Swap is an over-the counter derivative contract in which two parties agree to exchange a series of cash flows on a future date. As a result, one party pays a variable series that will be determined by an underlying asset or rate and the other party pays either: ***(i)*** a variable series determined by a different underlying asset or rate; or ***(ii)*** a fixed series (Pirie, 2017). There are two (2) type of swap contracts:

Interest Rate Swap: This type of swaps is a contract under which both contracting parties agree to pay the other's interest accruing on monetary obligations in the same currency. Thus, cash flows are calculated over a nominal amount, denominated in the same currency, but different interest rates are exchanged. Generally, in this type of contract, one party receives flows with a fixed interest rate and the other party receives flows with a variable rate (Gorton & Rosen, 1995).

Currency Swap: Currency Swaps are contracts in which the contracting parties exchange cash flows through stream of interests and principal payments denominated in different currencies. The

applicable interest rate for the calculation of value is the market exchange rate agreed upon by the counterparties (Cooper & Mello, 1991).

1.3.2 Forwards and Futures

Forwards are over-the counter agreements under which one of the contracting parties assumes a short position by agreeing to sell and deliver an underlying asset at a future date and a certain price. The other party assumes a long position by agreeing to buy the underlying asset at future date for a specific price (Hull J. C., 2006). Forward contracts can be physically settled through the delivery of property or cash equivalent to the difference between the purchase price and the current market price (Feder, 2002).

Similarly, futures are a contract in which there is an agreement to buy or sell an underlying asset at a future date and specific price. The only difference is that future contracts are traded on an exchange market which provide standardized features of the agreement (Hull J. C., 2006).

1.3.3 Options

Option agreements provide the holder or buyer the right, but not the obligation, to acquire or sell an underlying asset, at a future date and at a specified price, in exchange for the payment of a premium. There are two specific mechanism through which an option contract can be executed, which are known as “call options” and “put options”: the “call option” enables the buyer to buy and the “put option” would provide the seller the right to sell the underlying asset or instruments (Saiti, 2016).

Resulting from the purchase of an option, the investor is required to pay an option premium for the right to purchase (in the scenario of a call options) or sell (in the case of a put option) property on or before a previously agreed-upon date and price. (Brunson, 2007)

2. Legal nature of Derivative Instruments

2.1 Atypical contract

Although there is a legal definition within Colombian financial regulations about derivative instruments, this type of contracts is still deemed "atypical" by legal scholars. Arrubla Paucar[12] defines typical contracts of the first order as a legal mechanism that, by gathering a certain behavior, orders and diversifies possibilities according to elements of each transaction, resulting in a special and single regulation. On the other hand, "typical" agreements of the second order are those that simply reference each type of agreements separately, requiring a particular characterization of the elements that feature each contract or agreement under analysis.

Thus, although financial regulations provide a definition and scope of application of derivative contracts, within the Colombian legal framework there is still no legal categorization of this type of contracts, resulting on financial derivative instruments being treated as atypical contracts (Mendoza, 2004). Furthermore, these contracts will be considered "atypical of the second order", until Civil and Commercial Law thoroughly regulate this matter with all the complexities contained in each type of instrument. In addition, legal scholars have not developed a broader "first order" group that facilitates a common treatment.

[12] Arrubla Paucar, J. A. (1998). Contratos Mercantiles (Tomo II). Contratos Atípicos 2 ed. Medellín: Biblioteca Juridica Dike.

2.2 Bilateral contract

A bilateral contract is an agreement between two contracting parties in which they are reciprocally obliged to do or not to do certain action which were agreed upon[13]. Therefore, considering the nature and structure of financial derivatives, they fall into the bilateral contracts category as each contracting party is responsible for the execution of certain obligations at a future date and under certain conditions.

2.3 Onerous Contract

Article 1497 of the Colombian Civil Code provides that a contract is onerous when both contracting parties pursue a profit from the execution of the agreement. Consequently, the execution of a financial derivative is onerous as both parties seek to obtain an economic benefit from the execution of the agreement.

2.4 Consensual contracts

In accordance with article 1500 of the Colombian Civil Code, contracts or agreements can be categorized as: ***(i)*** **Real:** Whenever the delivery of an item is required; ***(ii)*** **Solemn:** When the contract is subject to the compliance of certain special requirement that if not met will result on the agreement being null and void; ***(iii)*** **Consensual:** When the agreement is legally binding by the sole consent of the contracting parties.

The requirements for Real and Solemn agreements within Civil and Commercial Laws of Colombia are quite specific and do not apply to financial derivatives which should be classified as consensual contracts.

[13] Article 1496 of the Colombian Civil Code

2.5 Contracts subject to terms or conditions

As it was explained in the first chapter of this document, derivative instruments are always subject either to a term or a specific condition which enables the contracting parties to transfer risks. The concept of "Term" refers to a period precedent to the occurrence of a certain future event, whether determined or determinable, from which the effective enforcement or the extinction of a right or performance of an obligation depends. On the other hand, a condition is an uncertain future event whose occurrence entails the effectiveness of the obligations which were agreed upon subject to such conditions (Mendoza, 2004).

CHAPTER II-Corporate Income Tax and Deductibility of expenses

1. Corporate Income Tax and the Territoriality principle

Article 12 of the Colombian Tax Code determines that legal entities and corporations that meet certain legal requirements for residence in Colombia [14] are subject to taxation for Corporate Income tax-CIT purposes over their Colombian-source income and their foreign source income. Thus, according to Pardo Carrero, Colombian tax regulations start from a territoriality principle which is based on the relationship between the author or beneficiary of the execution of a taxable event and the national territory and from that departure point enlarges its coverage to worldwide income.

Moreno Perez states that there is a strong relationship between the source and territoriality principle within the Colombian tax legal framework, as the country tax regime is applied in accordance with the source of income and the taxpayer's residence.

However, the Colombian Tax Code does not provide a thorough and accurate definition of what should be understood as a Colombian-source income for CIT purposes. Article 24 of the CTC determines that Colombian-source income is that: "*Derived from the exploitation of material and immaterial goods within the country and the provision of services within its territory, on a permanent or temporary basis, with or without its own establishment. Income from the sale of tangible and intangible assets, in any form, which are located within the country at the time of their sale are also considered as Colombian-source income*[15].

[14] Articulo 12-1 del Estatuto Tributario- Concepto de sociedades y entidades nacionales para efectos tributarios: Se consideran nacionales para efectos tributarios las sociedades y entidades que durante el respectivo año o periodo gravable tengan su sede efectiva de administración en el territorio colombiano.
También se consideran nacionales para efectos tributarios las sociedades y entidades que cumplan con cualquiera de las siguientes condiciones: 1. Tener su domicilio principal en el territorio colombiano; o 2. Haber sido constituidas en Colombia, de acuerdo con las leyes vigentes en el país.

[15] Artículo 24 del Estatuto Tributario- Ingresos de fuente nacional: Se consideran ingresos de fuente nacional los provenientes de la explotación de bienes materiales e inmateriales dentro del país y la prestación de servicios dentro de su territorio, de manera permanente o transitoria, con o sin establecimiento propio. También constituyen ingresos de fuente nacional los obtenidos en la enajenación de bienes materiales e inmateriales, a cualquier título, que se encuentren dentro del país al momento de su enajenación.

This tax regulation regarding to the CIT rises the following issues: ***(i)*** There is no definition of Colombian-source income but rather a description of types of incomes that fall into this category; ***(ii)*** the list of three types of income which can be deemed as national-source income is not limitative; ***(iii)*** The territoriality principle ("within the country") is not easy to apply to financial transaction where counterparts are located overseas (Thompson, 2018).

Thus, there is an absence of a systematic regulation which would provide a clear concept of what can be deemed as a Colombian-source income particularly in connection with complex financial transactions that involve a number of players in Colombia and abroad. Article 25 of the CTC lists other types of income deemed as foreign source income, but similarly fails to provide an accurate definition (Thompson, 2018)[16].

The taxable event of the CIT is broadly described as income which actually or potentially generates an increase on the net equity of a legal entity or individual resident in Colombia. Furthermore, for taxable period 2021, the applicable rate is of thirty-one percent (31%)[17].

2. Deductibility of expenses for Corporate Income Tax purposes

In accordance with the provisions of the Colombian tax regulations, costs and expenses that comply with the following requirements, amongst others (depending on specific business scenarios) can be deemed deductible for CIT purposes:

[16] The Supreme Administrative Court (*Consejo de Estado*) in Ruling (*Sentencia*) No. 17942 of 2012 has maintained that for CIT purposes, the "source" principle is one of the criteria for the application of the tax regime. According to that principle, the territory where the income-producing activity takes place or where rights deriving from income are exercised or where assets from which the income are also derived will be decisive to determine the applicable taxation regime

[17] Article 240 of the Colombian Tax Code

Those which are deemed as an expense according to accounting techniques: Article 21-1 of the CTC provides that for the determination of the CIT, the value of assets, liabilities, equity, income, costs, and expenses, should be measured and recognized, in accordance with the Accounting technical frameworks.

Furthermore, article 59 of the CTC mandates that in the case of taxpayers required to keep accounting records, for tax purposes realized costs and expenses are those accrued for accounting purposes in the applicable fiscal year or taxable period.

Expenses which have a necessary, proportionate, and causal relation with the income producing activity: According to article 107 of the CTC, as a general rule, for any expense or cost to be deductible from the corporate income tax, it must comply with the requirements of **necessity, proportionality and causal relationship** with the income producing activity.

The previously mentioned requirements have not been defined by tax regulations but rather by the Supreme Administrative Court, as of 2011 ruling[18] the Court established a unified line of interpretation for the three previously mentioned requirements as follows:

Ruling No. 17187 of January 27th, 2011 established:

"According to Article 107 of the Colombian Tax Code, a necessary expense is that which is carried out during the year or taxable period in the exercise of any income producing activity, provided that it has a causal relationship with the income producing activities, and that it is necessary and proportionate in accordance with each activity. The rule provides that the necessity and

[18] Prior to this taxable period, it was quite common to stumble upon case-law stating that the criteria for determining whether or not there was a necessary and casual relationship was defined according to the income generated and not the activity itself.

proportionality of the expenses must be determined with commercial criteria, considering those normally used in each activity.

For Tax purposes, necessary expenses are those generated in a mandatory manner in the income producing activity, so that without such expenses the income cannot be obtained. They are indispensable even if they are not permanent.

As the rule requires, the essential thing is that the expenditure should be "a common practice in each activity", therefore, excluding sumptuary, unnecessary or superfluous, or merely useful or convenient expenses.

For the Chamber, as it has reiterated on several occasions, the causal relationship means that the expenditures or simply the outflow of resources from the taxpayer, must have a causal relationship, of origin - effect, with the activity or occupation that generates the income for the taxpayer. That relationship, link or correspondence must be established between the expense (cost or expenditure) and the activity for the development of the corporate purpose (main or secondary), but in any case it produces the income, so that without it is not possible to obtain it, and that relationship.

As for proportionality, this takes into account the magnitude that the expenses represent within the total of the gross income (gross profit), which must be measured and analyzed in each case, in accordance with the economic activity that is carried out and commercial custom for the sector."

Additionally, in Ruling No. 17075 of March 10th, 2011, the Supreme Administrative Court said:

" Expenditures are the costs and expenses that involve the outflow of resources or simply represent outflow.

By causal relationship we must understand the connection that exists between the expense (cause) made in any income producing activity by the taxpayer during the year or taxable period, with the income generating activity, or better, with the productivity of the company, a connection which is measured by the interference (nexus) that the expense has in such activity and, therefore, in such productivity (effect).

As for necessity, the adjective "necessary" in its grammatical meaning implies "That something is done and executed by obligation, as opposed to voluntary and spontaneous."

And, regarding proportionality, as the Chamber has indicated, it should take into consideration the magnitude that the expenses represents within the total gross income (gross profit).

Now, both necessity and proportionality must be measured with a commercial criterion and, for this purpose, Article 107 of the CTC provides two parameters of analysis. The first, is that the expenses are measured considering that it is an expense normally used in each activity. The second, that the law does not limit the expense as deductible".

On the other hand, Ruling No. 18488 of November 21st, 2012 of the Supreme Administrative Court states:

"According to the legal provision, these are essential prerequisites for the expenses to be deductible, to have a causal relationship with the income producing activity, to be necessary and proportional.

A causal relationship is understood to be the link between the expense and the income obtained, thus, it is not possible to produce the income, if the expense is not incurred; for its part,

necessity implies that the expense intervenes directly or indirectly in effectively obtaining of the income, that is, that it helps to produce it, as opposed to the merely useful or convenient expense.

Necessary expenses correspond to the expenses that are inevitably generated in the income producing activity, so that without such expenses the income cannot be obtained. They are indispensable even if they are not permanent. As the rule requires, the essential factor is that the expenditure should be "a common practice in each activity", which excludes that it be simply sumptuary, unnecessary or superfluous, or merely useful or convenient".

On the other hand, the proportionality of the expenses, refers to the magnitude that they represent within the total gross income (gross profit), which must be measured and analyzed in each case in accordance with the lucrative activity that is carried out, in accordance with the commercial practices for that sector, in such a way that the regulatory rigor will yield to the repeated, uniform and common expenses that are made, without prejudice to the causality and necessity that must also be complied with".

Consequently, the three requirements assessed throughout the case law of the Supreme Administrative Court can be summarized as follows: ***(i)*** **Causal relationship with the income producing activity:** The expense must be one of those normally incurred in a given economic activity, which must have a cause-effect relationship between the expense and the income generated in the development of said activity. In other words, it is the link that must be established between the cost or expense and the activity being executed (the main or secondary corporate purpose) which is the one that produces the income, in such a way that without the expense it is not possible to obtain

such income[19]; ***(ii)*** **Necessary for the income producing activity:** Meaning that expenses are mandatory for the income producing activity in such a way that without these expenses it would not be possible to obtain income. In other words, the expenses are indispensable and can be permanent or occasional. The essential criteria for its determination are that the expense is *"normally incurred in each activity"*. Therefore, unnecessary or superfluous expenses do not comply with this requirement[20]; ***(iii)*** **Proportionate with the income producing activity:** The expense should be proportionate to the income perceived, considering that here is a threshold for the expenditure, which is measured by the ratio of the magnitude of the expense to the benefit that can be obtained. This requirement must be determined with a commercial criterion, considering those normally used in the activity and subject to the limits specified by the tax law.

Other requirements: In the case of foreign expenses, in addition to the previously mentioned legal requirements for deductibility, certain special rules established in articles 121 and 122 of the CTC must be met. First, article 121of the CTC accepts that expenses incurred abroad which were subject by law to a withholding tax, are 100% deductible for CIT purposes.

On the other hand, Article 122 CTC allows the deductibility of expenses abroad, limiting them to 15% of the net income of the taxpayer before crediting such expenses. However, a withholding tax is not mandatory in this case.

[19] Supreme Administrative Court. Fourth Chamber. Ruling from August 10th, 2017. Exp. 20951 C.P. Jorge Octavio Ramirez
[20] Ibídem

CHAPTER III- Derivative instruments implications on the Corporate Income Tax

1. Taxation issues related to Derivative instruments

Taxation of derivatives (irrespective of whether the transactions are executed on a domestic or cross-border level) pose a serious challenge for lawmakers around the world. Overall, the current state-of-the-art of tax regulations imposed on financial instruments remains extremely uncertain and limited. Consequently, according to Weidmann to determine a precise tax treatment for derivatives, the following issues have been identified: ***(i)*** An appropriate definition of derivative instruments for tax purposes; ***(ii)*** Applicability of a special taxation regime or the application of general tax rules for derivatives; ***(iii)*** Derivatives executed between cross-border parties; and ***(iv)*** Taxation of hedging transactions.

First, the absence of an appropriate specific definition of derivative instruments for tax purposes or a broader description of what should be understood as a derivative may cause that the income generated by such instruments does not fall within traditional categories of income and the uncertainty arising from that vacuum or ambiguous definitions could cause under or over taxation of income (Weidmann, 2015).

Second, the complexity of innovative financial instruments may particularly affect derivatives executed on a local or cross-border level, as the tax treatment as income or capital gains varies depending on the jurisdictions involved in the operation.

Third, cross-border derivatives are most likely to cause interpretation problems to determine the possible application of withholding taxes on such operations in accordance with the source country regulations, considering that unilateral tax rules usually determine whether or not it is acceptable to impose withholding taxes on the payment of premiums derived from the execution of such operations

(Weidmann, 2015). In addition, Double Taxation Treaties must be considered when analyzing the tax implications of derivatives, as in the applicable cases taxation within the source country my typically allow for a tax credit or exemption by the counterpart country.

For the time being, Colombia has subscribed the following Double Taxation Treaties:

Double Taxation Treaties	
Country	**Law**
Canada	Law 1459 of 2011
Chile	Law 1261 of 2008
Czech Republic	Law 1690 of 2013
Spain	Law 1082 of 2006
Mexico	Law 1568 of 2012
Portugal	Law 1693 of 2013
South Korea	Law 1667 of 2013
Switzerland	Law 1344 of 2009
India	Law 1668 of 2013
United Kingdom	Law 1939 of 2018
Andean Community of Nations-CAN (Bolivia, Peru, Ecuador)	Decision No. 578 of 2004

Unfortunately, none of these treaties provides a specific treatment for the taxation of derivative instruments which would have helped reducing a great deal of uncertainty at a cross-border level, considering that there may be inconsistencies in the legal treatment applicable to the parties involved in such transactions.

Lastly, as the number of taxpayers who use hedging operations to mitigate risks has increased over the years, tax authorities are required to assess whether the applicable tax regulation facilitates an efficient management of exposure to risk or it is being used inconsistently enabling tax-free gains or tax avoidance (Donohoe, 2011).

2. Taxation of derivative instruments under Colombian tax regulations

Both articles 33 and 33-1 of the CTC refer to the applicable treatment on income arising from the execution of derivative instruments. Numeral 3 of Article 33 provides that:

"For tax purposes, financial instruments measured at fair value will be treated as follows: (...)

Financial derivative instruments: Income, costs and expenses accrued by these instruments shall not be subject to Corporate Income tax and Capital Gains until the time of their disposal or liquidation, whichever occurs first[21]*."*

This particular provision applies to financial instruments measured at a fair value which is subject to change in market valuation, meaning, those which are *"held for trading purposes and their yield includes factors other than or additional to interests"*[22].

Thus, two practical conclusions can be drawn from the tax rule: ***(i)*** it is only applicable to financial instruments measured at fair value, such as derivatives instruments and therefore there is a specific tax provision which regulates the matter; ***(ii)*** for financial derivative instruments, tax accrual is generated at the time of sale or settlement.

Regarding the first conclusion, it is important to clarify that as mentioned in IFRS 9, as a general rule, financial liabilities are measured at amortized cost while some exceptions (including -in this case- financial derivatives) are measured at fair value[23].

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[21] Artículo 33 del Estatuto Tributario- Tratamiento tributario de instrumentos financieros medidos a valor razonable: "*Los ingresos, costos y gastos devengados por estos instrumentos, no serán objeto del impuesto sobre la renta y complementarios sino hasta el momento de su enajenación o liquidación, lo que suceda primero."*

[22] Explanatory Memorandum *"por medio del cual se adopta una reforma tributaria estructural, se fortalecen los mecanismos para la lucha contra la evasión y elusión fiscal, y se dictan otras disposiciones"* (Ley 1819 de 2016) Annex – Rationale on provisions for legal entities

[23] International Financial Reporting Standards IFRS 9- Financial Instruments

Now, with respect to the liquidation of the derivative instrument, in accordance with the definition provided by article 2.35.1.1.1 of Executive Decree 2555 of 2010, the settlement or liquidation takes place after contract effectiveness (understood as the date in which the parties agree that the hedge will apply).

On the other hand, the provisions of article 33-1 must also be taken into consideration:

"Income, costs and expenses from financial instruments measured at amortized cost are deemed to be realized in accordance with the first paragraph of Article 28, 59, 105 of the CTC"

As a general rule, the accrual of income and expenses (articles 27, 28, 59 and 105 of the CTC) happens at the time that the right/obligation to claim/make the payment arises even if it has not been paid.

In any case, it should be made clear that there is no tax regulation or tax authority opinion that defines what is understood by the settlement date of these contracts, therefore, it is critical to refer to the provisions established for financial purposes.

Consequently, the Colombian Tax Code provides a distinct treatment for equity securities and fixed income securities, a concept that may extend to derivatives. Income, costs, or expenses generated through equity securities are assessed at the time in which the financial derivative is sold or liquidated. On the other hand, regarding fixed income securities an analysis must be made about the value of the underlying asset to account for the financial yields or interest to be assessed for tax purposes. Similarly, the profit or loss obtained on the sale of a security will be assessed at the time of sale or liquidation.

In addition, article 1 of Executive Decree No.1514 of 1998 provides that in financial derivative contracts which do not require the delivery of an underlying asset, the difference between the value of

such asset as defined in the contract and the market value at the time of the settlement of the contract will be taxable income subject to standard corporate rates. By contrast, in the case of a financial derivative which requires the delivery of an underlying asset the applicable tax treatment will be determined according to the nature and characteristics of the delivered asset[24].

The regulations on derivative instruments established by Executive Decree No. 1625 of 2016 ("DURT" per its acronym in Spanish) are also relevant. Firstly, article 1.2.1.7.4 of the DURT mandates that:

"In derivative transactions, income is understood to be received at the time of maturity of each contract.

For tax purposes, it is understood that a single contract groups all the operations carried out under the same type of contract (forward, future, option, etc.), by the same taxpayer, on the same underlying and with the same maturity date. Likewise, in the event that the taxpayer carries out operations that result in the closing of its position in the respective contract, the respective income is understood to be caused at the expiry date of the respective contract"

However, this regulation seems to be contradictory with the provisions of article 33 and 33-1 of the CTC, as it commands that income should be deemed received at the time of maturity of each contract. Nevertheless, with regards to financial instruments measured at fair value, this regulation: ***(i)*** Is of lower hierarchy than the provisions of the CTC and ***(ii)*** was enacted before the entry in effect of Law 1819 of 2016 so it may have been the subject of implied repeal.

[24] Article 7 of Executive Decree No. 1797 of 2008

On this matter article 71 of the Civil Code rules that:

"The repeal of laws may be expressed or implied. It is expressed, when the new law expressly states that it repeals the old law. It is implied, when the new law contains provisions that cannot be reconciled with those of the old law.

The repeal of a law may be total or partial."[25]

Therefore, on this particular scenario an implied repeal of article 1.2.1.7.4 may operate, as it is contrary to a subsequent legal rule (Law 1819 of 2016), thereby losing any legal force.

Article 1.2.4.2.55 of the DURT explains the treatment of income from this type of contract, as follows:

"For purposes of the provisions of Article 401 of the Colombian Tax Code, in forward contracts, options, futures and financial compliance term operations, which are fulfilled without the delivery of the underlying asset, the difference existing between the value of the index, rate or price defined in the corresponding agreements and the market value of the index, rate or price on the settlement date of the contract constitutes levied income."

Paragraph. Regarding the income from forward contracts, options, futures and term operations of effective compliance, which are fulfilled through the delivery of the underlying asset, the applicable tax treatment and rate should be in accordance with the concept and characteristics of the delivery of the corresponding asset."

[25] Artículo 71 del Código Civil: "*La derogación de las leyes podrá ser expresa o tácita. Es expresa, cuando la nueva ley dice expresamente que deroga la antigua. Es tácita, cuando la nueva ley contiene disposiciones que no pueden conciliarse con las de la ley anterior. La derogación de una ley puede ser total o parcial."*

This regulation highlights a difference between delivery and non-delivery contracts, as in the former the income tax will be treated according to the nature of the underlying asset.

3. Applicable tax treatment on hedging operations according to the Colombian Tax and Customs Authority-DIAN

3.1. Legal nature of official opinions issued by the DIAN

To fulfill the objectives and functions of a social state under the rule of law, a government may use various actions, considering the difficulty and complexity of the task (Marín, 2008). Among the actions used, an administrative act is the most common method of legal action of the administration. Such act is the result of the unilateral will of those who exercise administrative functions aimed at producing legal effects [26].

However, there are different types of other actions that convey an interpretation, desire or wish of the administration but have neither the scope nor the effect of a typical administrative act. Since they are not intended to generate effects on the legal rights of individuals, but rather provide an interpretation of certain legal norms, in connection with the issuing of decisions and the carrying out of administrative operations, or to guide citizens in the fulfillment of their duties vis-à-vis the administration (Marín, 2008). A good example of this type of acts are the official opinions issued by the Tax Authority-DIAN.

In accordance with Article 1 of Decree-Law 1071 of 1999 the DIAN is organized as a special administrative unit of the national level of an eminently technical and specialized nature, with legal status, administrative and budgetary autonomy, reporting to the Ministry of Finance and Public Credit.

[26] JAIME ORLANDO SANTOFIMIO G., *Tratado de Derecho Administrativo,* Bogotá, Universidad Externado de Colombia, 1998, p. 128.

The objective of the DIAN is to guarantee the fiscal security of Colombia, by protecting the national economic public order through the administration and control of compliance with tax obligations[27].

Although recently the Ministry of Finance and Public Credit issued Executive Decree No. 1742 of 2020, there were no changes to the legal nature of the DIAN, however the previously mentioned Executive Decree did modify the structure of the Tax Authority. As the national Tax authority[28], the DIAN is entitled to interpret tax rules and act as a statistical authority regarding national taxes[29], thus, providing answers on general inquiries posed on tax and customs matters by any individual.

Nevertheless, official opinions issued by the Tax Authority are subject to control before the Administrative jurisdiction, through a judicial review mechanism (*acción de nulidad simple*)[30], to determine whether the opinion is consistent with the provisions of the Constitution or other laws.

Furthermore, official opinions issued by the tax authority constitute official interpretation solely for DIAN officials, being mandatory only for said employees while taxpayers are obliged to base their actions only on the provisions of the law and regulations and may or may not follow the official DIAN opinions [31].

Consequently, official opinions issued by the DIAN are not considered legally binding, but rather serve as an interpretation of laws and regulations on tax matters, a legal status that has been also confirmed by the Case-Law of the Constitutional Court[32] and the Supreme Administrative Court[33].

[27] Article 4 of Decree-Law 1071 of 1999
[28] Article 1 of Executive Decree 1321 of 2011
[29] Article 2 of Executive Decree 1321 of 2011
[30] Article 138 of Law 1437 of 2018-Administrative Code (*Código de Procedimiento Administrativo y de lo Contencioso Administrativo*).
[31] Article 131 of Law 2010 of 2019
[32] Ruling No. C-487 of 1996
[33] Ruling No. 14699 of 2005 and 21249 of 2015 CP. Jorge Octavio Ramirez Ramírez

3.2. Applicable DIAN Official Opinions on Derivative Instruments and Hedging operations

The applicable tax treatment on income perceived from the execution of Hedging operations between a Colombian entity and a foreign financial institution (provider of the service) has been subject to two (2) different interpretations by the Tax Authority-DIAN.

The first analysis on the matter was made through means of **Official Opinion No. 02607 of 2005**[34], in which the tax authority was consulted on whether the payment made from a Colombian entity to a foreign entity, related to the execution of a hedging operation under a Forward contract should be subject in Colombia to the withholding tax mechanism. On that occasion, based on the provisions of Executive Decree No. 1514 of 1998 the tax authority determined that in a scenario in which a derivative instrument is subscribed between a foreign entity and a Colombian legal entity, the payment made by the Colombian entity is considered as a Colombian-source income under the category of a "payment abroad" and thus subject to a withholding tax.

The tax treatment provided through this Official Opinion, significantly differs from a consistent international treatment on the subject based on the residence principle[35], allowing the jurisdiction in which the entity receiving the income is domiciled to be the only one entitled to tax such income (Salcedo Younes, 2008). This would imply that payments arising from the execution of a hedging operation between a Colombian entity and an entity from abroad (provider of the hedging service) must be treated as a foreign source income in Colombia for the latter irrespective of tax residence.

[34] Official Opinion No. 02607 of January 19th ,2005

[35] Olivier maintains that a residence-based taxation is usually justified on the fact that the resident enjoys the protection of the state, and he/she should contribute towards the cost of the government of the country in which he/she resides, even if the income is earned abroad.

Consequently, the Colombian Tax Authority was asked once again whether hedging operations executed between a Colombian entity and a foreign entity are levied for Corporate Income Tax purposes. Through **Official Opinion No. 19266 of 2005** DIAN reconsidered its initial interpretation base on the following arguments:

- First, international financial derivative agreements, allow legal entities domiciled for tax purposes in Colombia to transfer to a foreign entity the financial risks to which they are exposed under a business activity. Under these conditions, the foreign entity provides a hedging service to the Colombian entity against the risk of market fluctuations.

- A service like this is provided from abroad because the entity that carries out hedging is typically not domiciled in Colombia, and because the financial operation is effectively conducted outside Colombia even though the beneficiary of such service is located in Colombian territory.

- As a result, the income derived from hedging operations rendered by an entity not domiciled in Colombia, cannot be deemed Colombian-source income, in accordance with the provisions of article 24 of the CTC and the territoriality principle or *"estatuto real"*. Therefore, the income received from the operation will be deemed as a foreign source income thereby not triggering the withholding tax mechanism for CIT purposes. Finally, Official Opinion No. 02607 of 2005 was repealed.

In a more recent interpretation (Official Opinion No. 12358 of 2016), the Tax Authority has reiterated the arguments and conclusions set forth in Official Opinion No. 19266 of 2005. In this opinion, the DIAN provided a further relevant clarification: it does not matter whether the underlying

asset is located within Colombia or abroad, as hedging contracts are independent of the underlying asset that they seek to cover.

3.3. Overview of the tax implications according to the DIAN

Therefore, the Colombian tax administration interprets that hedging operations through derivative contracts cover financial risks of local residents with the assistance of foreign entities providing those "risk-management services". The scope of such services extends to various possible contingencies which may or may not arise affecting the underlying asset connected with the financial instrument.

When the risk-management service is rendered by an entity not resident in Colombia (a foreign entity), the income received is not deemed a Colombian source income, as such services would not meet the requirements of Article 24 of the CTC. However, for this analysis the tax administration does not take into account whether the underlying asset is located in the national territory as hedging operations are independent from such underlying asset. The operation would always be deemed as a foreign source income regardless of who provides the services abroad (a financial institution or not).

Thus, a withholding tax is not applicable on the hedging services provided from abroad through financial derivatives such as Swaps or Forwards, agreed upon with foreign entities. Nevertheless, official opinions issued by the DIAN are only binding for DIAN officials, therefore, taxpayers could provide further arguments for different tax treatments in accordance with their own interpretation of legal provisions, which lead to diverse from interpretations issued and established by the DIAN thereby generating legal uncertainty.

Finally, it could be argued that additional to the arguments established by the Tax Authority on whether the operation should be subject to a withholding tax. It is noticeable that the inapplicability of such withholdings is a feasible interpretation due to the lack of regulations on the matter.

4. Applicable tax treatment on hedging operations according to the Supreme Administrative Court

The Supreme Administrative Court has reviewed and analyzed the applicable tax treatment to hedging operations regarding to the deductibility of the expenses associated with the entering into of financial derivatives between a Colombian legal entity and a foreign one. Although, the core of the analysis made by the Court is based on deciding whether or not said expenses are deductible for CIT purposes, in order to make such decision the Court had first to consider whether or not income arising from the subscription of said contracts can be deemed Colombian source-income.

4.1. Review of Case-Law from the Supreme Administrative Court regarding hedging operations

In **Ruling No. 16886 of 2010**[36] the court had to decide whether or not the losses generated from the execution of forward agreements between a Colombian legal entity and several foreign financial institutions[37] met the requirements for deductibility of expenses in accordance with article 107 of the CTC.

To start the Chamber established that by including losses from derivative agreements as a deductible foreign expense, the plaintiffs CIT return was affected by several inaccuracies so that the

[36] Ruling No. 16886 of 2010. Consejo de Estado. SALA DE LO CONTENCIOSO ADMINISTRATIVO SECCIÓN CUARTA. CONSEJERO PONENTE: Hugo Fernando Bastidas Bárcenas

[37] The forward agreements under analysis were subscribed with Standard Chartered, Citibank Nassau and Lehman Brothers (All foreign financial institutions). The losses generated from the executions of the contracts amounted to a value of COP $2.995.607.071

expenses failed to comply with requirements set forth in Articles 107, 121 and 122 of the CTC, specifically regarding the proportionality criteria, as well as a lack of proper documentation on the transactions under analysis. In addition, the Chamber noted that in accordance with article 24 of the CTC payments made to foreign entities are considered as Colombian-source income only if the beneficiary of such payment carries out any activity of exploitation or sale of goods within Colombian territory, which was not the case. Thus, the income received from the financial derivative is considered as a foreign source income to the extent that the hedging operations were performed abroad.

The hedging operations of the plaintiff were aimed at reducing to zero the risk of exposure of its financial statements in pesos at the time of their conversion to dollars, which was achieved by hedging the possible imbalance arising as a result of the devaluation. Thus, there was no causal relationship with the income producing activity of the Colombian entity. These premises allowed the Chamber to conclude that: ***(i)*** the payments received by that foreign financial institutions should be deemed foreign source income; ***(ii)*** the payments considered foreign-source income are not subject to the withholding tax mechanism for CIT purposes; ***(iii)*** Consequently, this type of expenses is not deductible from the CIT return.

In **Ruling No. 18882 of 2014,** the Chamber had to decide on deductibility of expenses arising from the execution of hedging derivative instruments subscribed between Colombian legal entities[38]. The Court made a thorough analysis of the legal nature of derivative instruments and determined that financial derivatives are "atypical contracts", which have not been properly regulated throughout the

[38] The case under analysis is centered on whether deduction of expenses arising from losses in the execution of Forward agreements are associated with income producing activities.

Colombian legal framework, thus, their legal effects should be determined in accordance with general regulations.

In addition, the Court observed that derivative instruments are considered as self-standing contracts since they do not require any other agreement or obligation to exist. Therefore, the Chamber followed the scholars' standpoint that has determined that derivative instruments are governed by the principle of separate transaction which considers them separate and independent from the underlying asset [39]. Consequently, these instruments do not depend on such asset because their purpose is not the acquisition of a good or service but the transfer of risks. Thus, income or expenses derived from the hedging operations are only determined through the profits or losses resulting from the final settlement of these instruments.

The Court continued saying that although hedging operations do not have a specific regulation either from a civil, financial or tax laws in Colombia, the deductibility of the expense cannot be rejected only on such basis, but rather the applicability of articles 107, 121 and 122 must be analyzed simultaneously. As a result, according the Chamber, for hedging operations between Colombian legal entities it is clear that the deductibility of the expense under the above parameters, proceeds independently of the purpose of coverage or speculation of the operation, since in both cases, they constitute expenditures that are derived from the management of market risks. Furthermore, the court provides an interesting argument by stating that: *"resorting to this type of mechanisms is a valid and commonly used commercial practice, as it allows "predicting" the exchange market from which a*

[39] *A preliminary question that should be addressed before tackling the study of income tax on this type of contract is the relationship between the financial derivative instrument and the operation whose risk it is intended to cover or with which it is linked. For this purpose, the "principle of separate operations" is conventionally applied, according to which financial derivatives are "considered as separate and independent in relation to any related operation"*. (Salcedo Younes, 2008)

taxpayer obtains part of its income, and also mitigating the exchange risk" and proceeds to add that: *"Therefore, there is no justification to distinguish the origin of the expenses derived in the foreign trade hedging contracts, with the expenses generated in other hedging operations authorized by the financial entities in Colombia."* However, this particular assessment of the Supreme Administrative Court does not provide legal certainty, as it can also be superseded in absence of a clear regulation or treatment within Colombian law which defines the scope of the applicable tax treatment for hedging operations in Colombia and abroad.

4.2. Conclusions from the Case-Law of the Supreme Administrative Court

From the previously mentioned Case-Law, the Court has reached two conclusions. First, the expenses of the derivatives instruments are different from the expenses of the underlying asset, in accordance with the principle of separate transactions. In addition, losses derived from both speculative and hedging derivatives are deductible if they are necessary and proportional expenses and have a causal relationship with the income producing activity[40], an interpretation which has been shared by the Tax Authority's doctrine[41]. Second, payments made by a Colombian tax resident to a foreign entity are not deemed as Colombian-Source income and as a result, such expenses are not subject to withholding tax and therefore their deductibility is limited[42].

5. Taxation of Derivative instruments and hedging operations in the United States and United Kingdom

[40] Ruling No. 18882 of 2004
[41] Official Opinion No. 19266 of 2005
[42] However, on this matter the Tax Authority through means of Official Opinion No. 033738 of 2004 considered that the deductibility on expenses related to payments made abroad by a Colombian resident in compliance with the obligations contracted under a swap contract is feasible for CIT purposes.

5.1. United States

The US taxes companies on a worldwide basis, which as previously explained means that entities are levied over their total income whether it has been perceived within the country boundaries or outside (Lessambo, 2016). Sourcing regulations for tax purposes in the United States are established in Sections 861, 862, 863 and 865[43] of the Internal Revenue code-IRC. When it comes to taxing derivative instruments, the US regulations determines specific rules for each contract as follows:

- Forward Contracts: Whenever a forward contract is settled through the delivery of the underlying asset, the taxpayer effecting such delivery is required to recognize losses or gains arising from the difference between the price received and the taxpayer's basis in the asset. According to Section 1234 A of the IRC actual gains or losses must have the same treatment as the underlying asset.

- Future Contracts: For the purpose of future agreements, they are taxed as a Section 1256[44] contract, which means that any gains or losses obtained from such agreements, is treated as short-term capital gain or loss, as follows: ***(i)*** 40 % of the gain or loss-, and the remaining 60 % is treated as long term gain or loss. However, future contracts for hedging purposes, are not benefitted by this special-purpose rule.

[43] IRC 861 provides rules as to when specific classes of income are sourced within the U.S. IRC 862 specifies cases where the same classes of income are sourced outside the U.S. IRC 863(b) provides rules as to when specific classes of income are sourced partly within and partly without the U.S. IRC 863(c), (d), and (e) relate to other specialized sourcing items of income. IRC 864 provides definitions and special rules. IRC 865 provides rules for the sale of personal property.

[44] Pursuant to Section 1256, "Contract" is understood as: (A) any regulated futures contract, (B) any foreign currency contract, (C) any nonequity option, (D) any dealer equity option, and (E) any dealer of securities future contracts.

- Option contracts: Considering that gain or loss on an option contract should be recognized on a wait-and-see basis, the purchaser capitalizes the cost of his option premium, and the option writer does not immediately include it as income. The amount of gain or loss is determined whenever the option is exercised or sold. Furthermore, gain or loss recognized by the purchaser of an option is considered to have the same character as the underlying asset that the option is linked to (Lessambo, 2016).

  Nevertheless, according to Section 1221(a)(7) of the IRC if the purchaser of the option is a dealer in securities or any taxpayer executing a hedging transaction, the gain or loss should be treated as regular income.

- Swap contracts: According to IRC Section 446, swaps which contain a publicly traded equity are levied as a "notional principal contract", thus, requiring the parties involved to classify all payments thereto as either (i) a "periodic payment", (ii) a "non-periodic payment"; or (iii) a "termination payment".

  The characterization of payments as "periodic", "non-periodic", or "termination" requires different tax treatments. First, on a periodic and non-periodic payment, a taxpayer must recognize the ratable daily portions for the taxable year. On the other hand, with a termination payment, the taxpayer acknowledges income in the year the Swap is either assigned or terminated. Finally, equity swaps also deviate from the main income source-rule to the extent that the dividend equivalent payment is treated as non-US source income, not subject to US withholding tax (Lessambo, 2016).

- Hedging transactions: Section 1221 of the IRC determines that a hedging transaction must be understood as: *"any transaction entered into by the taxpayer in the normal course of the*

taxpayer's trade or business primarily— (i) to manage risk of price changes or currency fluctuations with respect to ordinary property which is held or to be held by the taxpayer, (ii) to manage risk of interest rate or price changes or currency fluctuations with respect to borrowings made or to be made, or ordinary obligations incurred or to be incurred, by the taxpayer, or (iii) to manage such other risks as the Secretary may prescribe in regulations."[45]. Furthermore, if a taxpayer identifies an operation as a hedging transaction, the actual gain from the transaction will be treated as ordinary income. Nevertheless, a special treatment is provided for income or expenses of foreign individuals or entities which are connected with a US trade or business, as follows: (i) the interest income of a foreign individual or legal entity resulting from a qualified hedging transaction entered into by such foreign person that satisfies the requirements of Treasury Regulation 1.988(a)(5)(vii) will be treated as effectively connected with a US trade or business and interest expenses will be allocated in accordance with section 1.882-5[46] of the regulations.

As previously shown, it is noticeable that the US Congress had selected a different time to levy taxes on the income received from a hedging transaction and the time the derivative itself is charged, as hedging transactions are subject to specific regulations[47] which determine the time in which qualified hedging gains or losses should be recognized (Oguttu, 2012). Finally, the applicable tax treatment on cross-border derivatives is not defined nor specified on the Double Taxation Treaties

[45] U.S. Code Title 26. INTERNAL REVENUE CODE Subtitle A. Income Taxes Chapter 1. NORMAL TAXES AND SURTAXES Subchapter P. Capital Gains and Losses Part III. GENERAL RULES FOR DETERMINING CAPITAL GAINS AND LOSSES.
[46] Electronic Code of Federal Regulations (e-CFR) Title 26 - Internal Revenue CHAPTER I - INTERNAL REVENUE SERVICE, DEPARTMENT OF THE TREASURY SUBCHAPTER A - INCOME TAX PART 1 - INCOME TAXES rules for computing credit for expenses of work incentive programs § 1.882-5 Determination of interest deduction.
[47] 26 CFR § 1.446-4 - Hedging transactions.

executed by the US, thus, causing uncertainty on the taxation of such financial instruments as domestic regulations still lack a thorough treatment.

5.2. United Kingdom

In the United Kingdom-UK resident companies are levied on their worldwide profits. Income tax is imposed on the total amount of income received from all sources, in the taxable period, which also include any capital gains.

In accordance with Section 576 of the Corporate Tax Act of 2009 for a financial instrument to be deemed a Derivative Contracts is must comply with the following three (3) requirements: *(i) It is one of* the applicable contracts (sections 577 and 578); ***(ii)*** Meets all the accounting conditions for the accounting period (section 579), and ***(iii)*** Is not prevented from being a derivative contract by section 589 (contracts excluded because of underlying subject matter) or any other provision of the Corporation Tax Acts.

Thus, in accordance with the previously mentioned regulations, a derivative contract is understood as a relevant contract if it qualifies as an Option[48], Future[49] or Margin Contract. However, although Option contracts are mentioned within the Corporate Tax Act, they are not defined for tax

[48] Option contracts are defined by Section 580 of the Corporate Tax Act of 2009 as follows: (*1) In this Part "option" includes a warrant. (2)References in this Part to an option do not include a contract whose terms—(a)provide— (i)that, after setting off their obligations to each other under the contract, a cash payment is to be made by one party to the other in respect of the excess, if any, or (ii) that each party is liable to make to the other party a cash payment in respect of all that party's obligations to the other under the contract, and(b)do not provide for the delivery of any property*

[49] Future contracts are defined through means of Section 581 of the Corporate Tax Act of 2009 and understood as follows: *1)In this Part "future" means a contract for the sale of property under which delivery is to be made—(a)at a future date agreed when the contract is made, and (b) at a price so agreed, but this is subject to subsection (3).(2)For the purposes of subsection (1)(b), a price is agreed when the contract is made even if—(a)the price is left to be determined by reference to the price at which a contract is to be entered into on a market or exchange or could be entered into at a time and place specified in the contract, or (b)in a case where the contract is expressed to be by reference to a standard lot and quality, provision is made for a variation in the price to take account of any variation in quantity or quality on delivery.*

purposes and solely mentioned as a security. In the case of Future contracts, the definition provided is still too broad in terms of scope of application and subsequent tax treatment, or even including other type of financial instruments within such broad definition. Thus, UK laws and regulations do not provide for a concrete definition and treatment of each one. For example, bearing in mind the definitions provided for a Future contract, it is possible to reach the conclusion that physically settled price swaps, as well as physically settled total return swaps could be within the scope of section 581.

Based on the above, it is noticeable that although some financial instruments are identified for corporate income tax purposes and there's an imbedded three-step plan in order to determine whether a financial instrument is considered a derivative contract for tax purposes, the scope and terms of the CIT is not thoroughly explained, resulting in a non-comprehensive tax regime for derivative instruments. Similar to the US, the UK Parliament has opted to distinguish between income arising from a derivative transaction and accruing from hedging transactions. Also, regarding the applicable tax treatment on cross-border derivatives there are no specific regulations on the matter; consequently, the DTT's subscribed by the UK do not portray any specific regulations about the tax treatment on this type of operations with economic players scattered across countries. However, there are local legal experts that believe the business profit article of the OECD model can be applied to gains arising from derivative contracts and in the case of the paid premium in swap contracts could be determined as other income and thus subject to a withholding tax.

6. Double Taxation Treaties, other incomes and the principle of non-discrimination

6.1. Overview of Double Taxation Treaties

Economic openness, free market and globalization have been considered as key factors to consider in tax regulations around the world. As a result, companies which carry out operations in

multiples jurisdictions must not only consider tax regulations from the country in which they have their tax residence, but also from all the jurisdictions in which they may carry out business (Trujillo, 2017).

Considering that most countries apply a dualistic approach in which there is taxation over both worldwide income of tax of residents and on domestic income of non-residents, as it has been previously explained throughout this essay, there is a high possibility for double taxation to arise[50] (Mosupa, 2003).

In order to avoid a negative of these principles on the country's economic performance (particularly to the detriment of local companies), an international instrument known as a Double Taxation Treaties is used. Such Treaty is usually entered into between two (2) countries[51] but very often follows the model established by the Organization for Economic Cooperation and Development-OECD. The objective of Double Taxation Treaties-DTT's is to avoid that taxes are levied in two different jurisdictions for the execution of the same income producing activity. To that end a set of rules are established on the agreements to provide for: ***(i)*** A contracting party to have the exclusive taxation power over the income in question or ***(ii)*** To allow a concurrent tax power to both contracting parties. When concurrent authority is granted, rules which limit taxation in one of them (generally the source state) are matched with rules that create mechanisms for the other (the residence state) to

[50] The phenomenon of international double taxation occurs when the same income of the same taxpayer is taxed in both the source country and the country of residence.

[51] The following Double Taxation Agreements have been signed by Colombia and are in full force and effect: Law 1459 of 2011- Colombia and Canada, Law 1261 of 2008- Colombia and Chile, Law 1082 of 2006-Colombia and Spain, Law 1568 of 2012-Colombia and Mexico, Law 1693 of 2013-Colombia and Portugal, Law 1690 of 2013 Colombia and Czech Republic, Law 1667 of 2009- Colombia and Switzerland, Law 1667 of 2013- Colombia and South Korea, Law 1668 of 2013-Colombia and India,

recognize the tax already paid in the other state as a tax credit or exempt income for CIT purposes (Cubides, 2009).

Furthermore, DTT's provide a thorough determination of the scope of certain rules such as: anti-abuse clauses, non-discrimination clauses, rules on matters considered of interest for both contracting states and other special provisions which are aimed at not only avoiding double taxation but also tax evasion (Cubides, 2009). [52]

6.2. Other income

Although DTT's includes specific provisions and regulations for a certain type of income, it is not possible to encompass all. As a result, the OECD model has determined the residual concept of other income[53], which should be applied to those profits which are not classifiable in other articles of the DTT (Sanchez, Vargas, & Parra, 2019). However, the scope and definition of other income is not established through the DTT nor does it provide a list of what types of incomes may be governed by such provision.

Thus, in a scenario such as the payment of a premium in a swap contract of a cross-border nature, the questions arise about whether it should be deemed as other income levied for CIT purposes by the source country and subsequently recognized as a tax credit by the other country. For an efficient taxation in such a scenario it would be necessary for the tax regulations of the countries involved in

[52] Chapter I Scope of the Convention: Article 1- Individuals and legal entities covered, Article 2-Taxes Covered. Chapter II Definitions: Article 3-General definitions, Article 4-Resident, Article 5-Permanent Establishment. Chapter III Taxation of Income: Article 6-Income from immovable property, Article 7-Business Profits, Article 8-International shipping and air transport, Article 9-Associated enterprises, Article 10-Dividends, Article 11-Interest, Article 12-Royalties, Article 13-Capital Gains, Article 14 Deleted, Article 15- Income from employment, Article 16- Director's Fees, Article 17-Entertainers and sportspersons, Article 18-Pensions, Article19-Government Services, Article 20-Students, Article 21-Other income. Chapter IV Taxation of Capital. Chapter V Methods for Elimination of Double Taxation: Article 23A-Exemption Method, Article 23B- Credit Method. Chapter VI: Special provisions

[53] Article 21-Other income

such transaction to have a comprehensive and coherent determination of how the income tax should be levied, in accordance with the source principles.

6.3. Principle of Nondiscrimination

As was previously mentioned, DTT's which follow the OECD model, contain a non-discrimination clause in article 24 which provides a limited scope of applicability and depends on the specific circumstances agreed upon by the contracting states (OECD, 2017) to regulate possible discrimination scenarios involving nationality[54], stateless individuals, permanent establishments[55], **expenses-related discrimination**[56], ownership-related discrimination and taxes covered (García Prats, 2014). For tax purposes, the main objective of this nondiscrimination clause is to guarantee that the source country does not levy an additional taxation burden on foreign investors compared to domestic investors (PwC, 2019).

The principle of nondiscrimination is important for our hedging case, as global financial markets operate in a way that there is a high possibility that a Colombian legal entity enters into a hedging transaction with a foreign entity located in a jurisdiction with whom Colombia has executed a DTT. Thus, in accordance with paragraph 4 of the OECD Model[57], the expense (despite not being subject to withholding tax) should be treated under the same conditions as if it were made between two Colombian entities, resulting on a one hundred percent 100% deductible expense not subject to the

[54] Paragraph 1 of Article 24 of the OECD (2017), Model Tax Convention on Income and on Capital: Condensed Version 2017, OECD Publishing.
[55] Paragraph 3 of Article 24 of the OECD (2017), Model Tax Convention on Income and on Capital: Condensed Version 2017, OECD Publishing.
[56] Paragraph 4 of Article 24 of the OECD (2017), Model Tax Convention on Income and on Capital: Condensed Version 2017, OECD Publishing.
[57] Aims at providing parity in deductibility of expenses to payers when a payment is made to non-residents, compared to payments made to residents. This paragraph provides for expense-related nondiscrimination for the benefit of payers (but not payees).

general ceiling of 15%. Nevertheless, each case should be carefully analyzed under Colombian tax legal frameworks to determine for the taxpayer's treatment applicable to their derivative operations.

7. Additional considerations when analyzing the applicable tax treatment on hedging operations-Deductibility limitations

As it has been previously explained, in accordance with expert opinions and case-law analysis of hedging operations with foreign entities, in principle, they are considered as a foreign source income and are not subject to a withholding but cannot be deducted. Even worse, if expenses arising from derivative instruments were deductible in some cases, they would be subject to the limitations established in article 122 of the CTC providing that *"costs or deductions for expenses abroad in order to acquire Colombian source income, cannot exceed fifteen percent (15%) of the taxpayers net income"*. Even if it is possible to argue that derivative instruments entered into with a foreign entity can be deductible such expense would be subject to a 15% ceiling over the taxpayers net income (Córdova, y otros, 2017), with a possible exception in cases in which the derivative instrument is executed between a Colombian entity and a foreign entity located in a country with whom a Double Taxation Treaty containing a non-discrimination clause is in force. Only under that scenario the expenses incurred on the execution of derivative instruments will be one hundred percent (100%) deductible (Castrillon Ordoñez, Casas Martinez, & Parra Pelaez, 2017).

8. Tax treatment on qualified services rendered from abroad

As it has been reiterated by the official opinions of the DIAN, that hedging operations are *services* in which a foreign entity helps a Colombian entity to mitigate possible market fluctuations that may have an impact on the *underlying* asset. This approach ultimately raises the question about whether derivative instruments can be treated within Colombian regulations as is the case of qualified

services as a Colombian-source income even though the services are being provided in its entirety from abroad?

8.1. Nature and definition of qualified services

In general terms, the withholding tax and the tax implications of payments made abroad depend on the nature and legal qualification of the services rendered under the following categories:

Technical Assistance: In accordance with the provisions of Article 1 of Executive Decree 2123 of 1975, technical assistance is the advice given through an agreement for the provision of intangible services, for the use of technological knowledge applied through the exercise of an art or technique. Such assistance also includes the training of individuals in the application of the knowledge shared.

Technical Services: There is no legal definition of a technical service. However, the Supreme Administrative Court, through Ruling No. 14124 of 2004, understands for technical services: *"advice given by means of an agreement for the provision of intangible services, for the use of technological knowledge applied directly through the exercise of an art or technique, without involving the transmission of knowledge."*

Consultancy: Although there is no legal definition of consultancy services in the current tax regulations, it has been understood that they refer to any type of specialized advice, different from those of a technological nature. Thus, in the absence of a legal definition, the Tax Administration has stated in its official opinion (No. 068312 of 2014) that consulting services are those defined as such in Article 32 of Law 80 of 1993, as follows:

"Consultancy agreements are those entered into by State entities for studies necessary for the execution of investment projects, diagnostic studies, pre-feasibility or feasibility studies for specific

programs or projects, as well as technical advice on coordination, control and supervision. Consultancy agreements are also those whose purpose is to intervene, advise, manage works or projects, direct, program and execute designs, plans, pre-projects and projects".

In the same Official Opinion, the Tax Administration indicates that this definition applies for tax purposes to "consulting agreements in general" which refers to agreements executed by individuals, involving advice on how to do things, and it is the responsibility of the beneficiary of the service to make a decision based on the advice received.

Furthermore, according to the provisions of Article 408 of the CTC, the income obtained from the rendering of qualified services is deemed as a Colombian source income, although it is provided from abroad and is subject to a withholding tax at a rate of twenty percent (20%). In these cases, the withholding tax is considered as the final tax applicable to the operation.

The previous review shows that for its most part the scope of the tax concept of "services" has been developed from official DIAN opinions and case-law. A common thread is that although the rendering of the services may be made from abroad, as long as the beneficiary is located in Colombia, the income obtained is deemed as a Colombian-source income. Thus, considering that the Tax Authority has already deemed hedging operations as a service it raises the question on to whether hedging operations should have a similar categorization, or a separate and different scope and concept is required to appropriately regulate its CIT treatment.

9. Conclusions

As it has been reiterated throughout this work, market risks and fluctuations pose serious challenges for taxpayers. As a result, Colombian legal entities which wish to mitigate such risks are required to subscribe hedging operations through means of financial derivative contracts.

Nevertheless, current financial, civil and tax law regulations do not provide a thorough definition and scope much required for the complexity of this type of transactions nor is their correct tax treatment clear for any taxpayer who wishes to engage in such operations.

Therefore, on the first hand the Colombian tax regime requires an urgent definition on to what is considered as a Colombian-source income and an appropriate distinction on what is otherwise deemed as a foreign source income. A thorough definition would most certainly provide the correct insight on whether hedging operations executed between a Colombian taxpayer and a foreign legal entity should be levied through a withholding tax for CIT purposes. Nonetheless, it is important to consider that although, the non-withholding reduces the cost of hedging operations (otherwise the foreign provider would increase the premia by the same amount of the withholding through a "gross-up"), the characterization as a foreign source income and subsequent non-deductibility is a disincentive for the use of derivative instruments to transfer risks from Colombian to foreign companies to the detriment of individual players in the local economy and potentially to the whole economy (in the case of a major crisis or disruption).

The absence on regulation on the matter, ultimately cripples the capability of levying cross-border derivatives as the tax authority will most likely struggle with the application of domestic tax regulations on payments perceived for the execution of this instrument, considering that such payments do not abide with traditional income descriptions.

Furthermore, the current Colombian taxation regime on financial derivatives and hedging operations is vastly insufficient and limited, thus generating a great deal of uncertainty for every taxpayer who engages in hedging transactions with foreign entities in order to mitigate market risks and fluctuations. In addition, in order to provide an appropriate analysis on the tax implications arising

from this type of transactions, it necessary for the Colombian legislator to clarify each of the elements which structure financial derivative contracts and their scope within civil, commercial and tax law.

Moreover, there is neither consistency nor coherence between the tax regulations currently in place for these financial instruments, as such regulations are contradictory about the time in which such operations should be taxed. In practice the regulations in force may turn out to be ineffective.

Therefore, specific regulations on this matter should be a priority for the legislative and executive branch of the government, as the complexity on this type of operations should not be taken lightly. Moreover, hedging operations are comparable to the purchasing of an insurance policy for consideration to the payment of a premium. When executing such operations under a cross-border basis, complete uncertainty remains on whether the payment made by the Colombian taxpayer should be subject to a withholding tax. For the time being, there is even uncertainty about the categorization of this type of services and their scope, raising the question on whether they should be categorized as a qualified service. A similar tax treatment would result on a withholding tax for CIT purposes at the time the premium is paid by the Colombian resident receiving such services.

In addition, from an international tax perspective there is no comprehensive or coherent treatment of derivatives instruments executed locally or on a cross-border level, as countries like the US and UK differentiate the tax treatment of derivatives from that of hedging transactions but lack a thorough definition of what should be understood for those transactions. Thus, a lack of consistency on the tax treatment for derivatives poses a major challenge for tax authorities in jurisdictions involved in this type of transactions such as Colombia that may not have an international benchmark to follow.

Finally, regulation on the matter will also provide a much-needed legal stability for the parties involved and eradicate the uncertainty currently affecting taxpayers. In the upcoming tax reform bill

the Colombian Congress must provide the tools for taxpayers to correctly categorize a derivative and distinguish it from other type of transactions. A special tax regime based on the overhaul of tax regulations for derivatives instruments and hedging operations could be useful for businesses requiring international hedging and should be based on the following principles:

- Symmetry: The parties involved in the execution of derivative instruments and hedging operations should be taxed under parallel country regulations in terms of timing and applicable rates. However, on cross-border level transactions this would pose a significant coordination challenge for tax authorities that could only be addressed in bilateral agreements/understandings.

- Consistency: The taxation of derivative instruments will be consistent if all economically comparable transactions are levied similarly. However, the implementation of this principle would most likely require a tax reform in Colombia and agreements/understandings with countries where major financial centers operate (US, UK, EU).

- Proportionality: Gains and losses generated from the execution of derivative instruments and hedging transactions must be subject to a balanced tax treatment, therefore, they must be levied at the same time and at the same rate irrespective of the location of the parties involved in the transaction..

The implementation of this principles would ultimately eliminate the uncertainty currently affecting taxpayers executing this type of transactions and may also help eradicating aggressive tax planning practices.

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