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Fostering Latin America's VC Ecosystems:
An Exclusive Interview with Susana Garcia-Robles (Multilateral Investment Fund)

By Alyson Sheehan (Thomson Reuters)

LALBR: You have previously reported that Latin America's venture capital (VC) ecosystem needs to have a continuum of angel investors, seed capital, early VC, growth capital and private equity. How would a lack of angel investors impact Latin America's VC ecosystem in the long run?

A lack of angel investors is one of the key issues in Latin America today, because funds are not going to be successful if they don't have the surroundings one can find in Silicon Valley. Of course, Silicon Valley is unique in the world, so everybody aims to emulate that ecosystem, but there are certain elements that we believe are really important for the continuum of financing.

The accent has to be on the entrepreneur. The entrepreneur has to have the support services, the location and the culture conducive to taking risk. Otherwise, VC becomes almost impossible, and the entrepreneur is not socially well-accepted, if he and it fail – and this is a big issue in Latin America. First, an ecosystem has to have entrepreneurs who truly understand risk-taking and who have access to service providers, who in turn can help entrepreneurs create compelling business plans. For example, entrepreneurs need access to service providers who are aware of the dynamics of early-stage investing, e.g., auditors who understand the challenges of assessing a start-up. In addition, countries need to have the appropriate legal and regulatory environments for VC, such as you would find in Silicon Valley, the UK or Canada.

It is very important for a country to have angel investors willing to take on risk. By example, the Chilean government launched Start-up Chile to facilitate VC development in the country. But according to a recent article, Chilean investors have invested considerably less money than investors overseas, which shows that locally there is no appetite for risk among angel investors or family offices. Angel networks in Latin America have had difficulty becoming really active for several reasons.

In Argentina and Brazil, many angel investors like to invest through funds, thereby delegating initial due diligence to a fund manager.

In some countries, it's due to security reasons. They don't want to emerge publicly as angel investors because they put their own families at risk. For example, in Colombia and Chile, angel investors tend to be very private. They feel that people who know they have the money and interest in investing will go directly to their offices; that they don't really need to gather together into a network. They can look at the projects that come directly to them, and if they don't want to commit all the money that the project needs, they can call their friends. They have that circle of trust. In Mexico the big issue has been security, but over the recent years, this has improved and there is an emergence of active angel networks in the country.

In Argentina and Brazil, many angel investors like to invest through funds, thereby delegating initial due diligence to a fund manager. With time, they may become more involved in the life of the fund, such as by navigating the commercialization and/or legal processes involved, or by helping the company to exit. So, angel investors in these countries are not passive, but rather they are active within the mechanics of a seed fund.

With all these factors in mind, we make an effort to invest in seed funds. And because we usually work with first-time fund managers, (it's a challenge to find fund managers with a track record of investing in seed funds in Latin America), the most we can ask a fund to raise is $20 million.

A fund that uses that $20 million to invest in 20 companies, for example, will ultimately run out of money

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Susana Garcia-Robles (susanaro@iadb.org) has worked at the Multilateral Investment Fund (MIF), an independent trust fund administered by the Inter American Development Bank, since 1999. Today, she is Principle Specialist in charge of the MIF Early Stage Equity Group, supervising the MIF portfolio of seed and VC funds as well as the MIF initiatives on entrepreneurship and building ecosystems conducive for VC in Latin America and the Caribbean. She is a Board member of the Latin American VC Association/LAVCA, an Advisory member of the Brazilian VC Association/ABVCAP, and a founder of the Argentinean VC Association/ARCAP.

VC Ecosystems (from page 3)

to support its companies offering high-growth potential. And then, there won't be other seed funds or angel investors who can provide that continuing financing. So that is one part of the ecosystem that is a threat to Latin America: if you don't get a critical mass in number of funds, the continuum gets broken.

So, putting all the different components of the VC ecosystem in place is very important. You have to have family-owned companies and multi-generational families who are willing to turn around companies; entrepreneurs with science, technology or engineering backgrounds and MBAs, who can foster innovation; banks that are willing to provide microloans to companies; governments and other institutions that support the research and development of good regulatory frameworks; and technical experts and advisors who are willing to mentor entrepreneurs and vouch for the credibility of an enterprise when it is being looked at by angel investors or seed funds.

In the end, a robust VC ecosystem is a combination of service provider support, culture, policy, willing and ready markets, human capital, and entrepreneurs who are not afraid to fail.

LALBR: MIF is targeting $4 million investments in two seed funds, one in Brazil and another in Mexico. Do Mexico and Brazil have the healthiest VC ecosystems in the region right now?

First, let's look at Mexico.

The MIF started working in Mexico in the mid-nineties, and it was an uphill battle. Business in Mexico was conducted in an old fashioned style: "I know you. You know me. I have your back, and you have mine." When it came to VC, the industry really didn't develop. It developed more on the big private equity (PE) deals, big names and big opportunities.

For us, it was really hard to find fund managers who really wanted to do VC. Once we did, then it became really hard to find investors who wanted to bet on VC funds (with the exception of the government and development financial institutions). However, something began to change when we invested in Latinidea there. Latinidea was, I would say, the first true VC fund in Mexico. With the exception of one deal, all the deals they did were start-ups or really early-stage companies. They are now raising a second fund that continues to be true to the mission of VC, but for awhile they were the lone riders in Mexico's VC industry.

A few years after Latinidea began working in the VC industry in Mexico, Alta Ventures was born in Monterrey. Alta Ventures has all the makings of a true seed/early-stage VC fund. In its first year, Alta Ventures has already invested in four companies and had one exit. Because of the short time in which the fund held the shares, the IRR of that exit was 2,358%, which is off the charts. The MIF invested in both Latinidea and Alta Ventures.

In Brazil, there is significant opportunity in sectors that improve the lives at the base of the pyramid (BoP). The BoP represents an underserved but also one of the biggest growing populations in Brazil. These are people who could become middle class if given the right incentives and opportunities.

For the last four years, MIF had been talking with Angel Ventures, which is the target of the recent $4 million investment in Mexico that you mentioned. In 2008, Angel Investors was a foundation trying to jumpstart angel networks in different points of the country. At the time, we felt that they needed to grow on their own and prove to the MIF that there was a true interest among the private sector for angel investors to have their own association. Last year, we went to look at them and what we found is that they had in fact developed angel networks. They are working in four cities in Mexico and still expanding. They have over 100 angel investors in their network. So like Alta Ventures, Angel Ventures has been trying to fill in the dots for Mexico's VC ecosystem to flourish.

Now we are seeing a new generation of Mexicans between the ages of 32-45 who have a novel business mentality. These are individuals who have studied or worked in the U.S. and who could have made great careers there, but who chose to return to Mexico and test out what they have seen in developed markets, in their own country. In a way, Mexico's VC ecosystem started upside down, because it began with PE, then moved to VC, then seed/early-stage VC, and then seed with angel investors. As of today, even though seed is still very limited, Mexico does have the makings of an ecosystem.

Now let's look at Brazil.

In Brazil, we have done a lot with the ecosystem since 2001 through the FINEP/MIF program, INOVAR, which is accountable for getting $1 billion to small and medium sized companies through the creation of VC funds. In later years, we have focused on seed funds through that program.

Brazilian seed capital fund C-Ventures (MIF's other recent $4 million investment) was analyzed by all the partners of INOVAR. What we liked about C-Ventures is the fact that it has an entrepreneur who had been totally exposed to the Silicon Valley approach to VC and founded a family office with more than five years investing in technology in the South of Brazil. In addition, one of the managers of C-Ventures was for many years the head of two technology parks, Sapiens Parque and Fundacao CERTI, and knows the southern region of Brazil, and its potential for small companies, very well.

We felt that C-Ventures wasn't exactly like Angel Ventures and therefore represented another model. It's a model where you have a family office; you have a guy who has a company that was incubated before it became an investment company; and you have a fund manager who has been exposed to all the good and bad aspects of incubators. Plus, you have an experienced fund manager, CRP, who has been in the southern part of Brazil for 35 years, acting as a mentor to the new fund manager.

So we feel that these two $4 million investments are very good, because they allow us to virtually test the VC ecosystems in two countries almost at the same time, since the investments were approved back to back. Mexico and Brazil are both big, but they are very different insofar as VC development.

LALBR: Traditional VC opportunities in the U.S. and elsewhere focus on the tech sector. You previously reported in LALBR that there are other sectors that VCs can capitalize on, besides technology, in Latin America. What would you say the most important sectors for VC development would be in Mexico and Brazil, if not technology?

In Brazil, there is significant opportunity in sectors that improve the lives at the base of the pyramid (BoP). The BoP represents an underserved but also one of the biggest growing populations in Brazil. These are people who could become middle class if given the right incentives and opportunities.

Funds that focus on the BoP target specific sectors: affordable housing, education, telecom, agribusiness and healthcare. For example, the BoP needs access to affordable clinics where people can go after work hours; clinics that offer great plans through not just corporations but also lower scale jobs. Funds targeting development in these areas are underdeveloped in Brazil.

We also think that Brazil is an underserved market when it comes to green and renewable energy. If you look at Brazil, you see a country replete with natural resources but one that is not big on green investing under a VC strategy. There are family offices investing in green/renewable energy but not under a VC/PE framework. The MIF invested in Stratus CleanTech I, one of the few funds to date in Brazil targeting this sector exclusively.

Another sector might be tourism. Brazil, like Peru, offers opportunity in tourism. However, we discourage funds that focus only on tourism, because it's a high risk sector. We invested in a tourism-focused fund in Mexico once, and even though the fund was performing well, nobody could foresee the outside factors that would come into play during the life of the fund: the wave of hurricane weather and the H1N1 virus, among other crises.

Argentina does not present a friendly environment for business. However, there are reasons to fall in love with it. There are three big poles of innovation and software development: Buenos Aires, Santa Fe, and Cordoba. There are incredible opportunities with entrepreneurs – young people who are developing video games and software. They also understand the mechanics of VC. If you have an appetite for risk, you should go to Argentina.

Looking at Mexico, there are huge opportunities in affordable housing. Mexico, like Brazil, has a solid, influential upper class, but it is the middle class that is growing and getting richer. To date, there is still a huge inequality gap. Brazil and Mexico are both known for having very poor populations, so both countries have to focus on that and use the doors of VC to provide services to the BoP. There are some funds already working on that mission in Mexico, such as IGNIA Partners and Adobe Mexico, and a few starting in Brazil, like Vox Capital and FIRST.

I would also say that a sector to watch is movies/video game development. Even though Argentina still leads in this area, we're beginning to see that area emerge in Mexico, Colombia and Brazil.

LALBR: What is happening in the VC ecosystems of Argentina, Chile and Colombia?

If you are based in the U.S. and have the opportunity to invest in either Colombia, Mexico, Brazil, Argentina or Chile, unless you have gone to Argentina, it is the country you would choose last. Argentina does not present a friendly environment for business. However, there are reasons to fall in love with it. There are three big poles of innovation and software development: Buenos Aires, Santa Fe, and Cordoba. There are incredible opportunities

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VC Ecosystems (from page 5)

with entrepreneurs – young people who are developing video games and software. They also understand the mechanics of VC. If you have an appetite for risk, you should go to Argentina.

Because of the leap-frogging in the industry, eventually Latin America will have something that no other region has come up with, but in the mean time VCs are experimenting and creating "copy-cats" that are adapted to local industries but still have the potential to go global. In this regard, Argentina is ahead of the curve, even vis-à-vis Chile, whose government has taken strides towards this effort with Start-up Chile. However, Chileans are not as prone to risk as Argentineans. Perhaps 5 years from now Chileans will be more open to risk, because certainly today they are much less averse to it than they were ten years ago.

As for Colombia, there are significant government initiatives doing a lot to facilitate VC development. However, the efforts could be better organized, so that is an item on the agenda that the MIF has discussed with the government. The Colombian government should try to make a fewer number of government agencies accountable for the development of the industry.

The MIF just approved a technical assistance program in Colombia to foster the creation of a VC association in Colombia as well as a VC institute, which would be for Colombia and the region. To date, Progresa is basically the only VC fund in Colombia. Other funds are more growth capital and PE. So, more efforts need to be made to create those funds in Colombia. A few years ago, when the industries started in Colombia and Peru, their pension funds had significant liquidity. As a pension fund is not likely to start with early stage – and, in my opinion, they shouldn't –, they started investing in growth capital and PE. So today, it's hard to find investors for VC in Colombia and Peru. Both countries need to be further supported in entrepreneurship, angel investors, and seed/early-stage investing. ❏

Latin American M&A Round-up for Year End 2011

By Mergermarket

Midmarket Activity Highest Since 2007

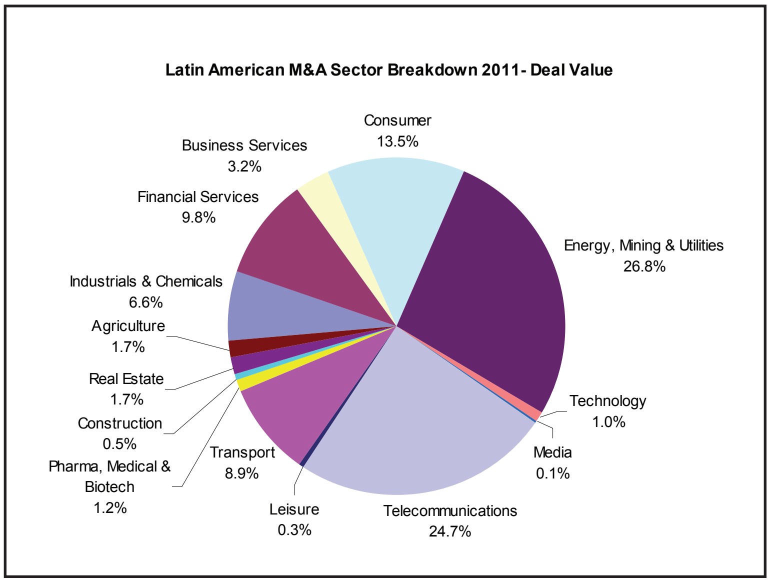
Latin America had an aggregate 606 deals worth US$ 131.5bn in 2011; a 19.8% decrease by deal value and a 23.4% increase by deal count compared to 2010 (491 transactions worth US$ 163.9bn). Meanwhile, midmarket activity saw 244 deals valued at US$ 17.5bn - the highest value and deal count since 2007, which saw 292 deals worth US$ 20.8bn.

Mexico M&A Decreases in 2011; Telecommunications Leads Market Share

After a record year in 2010 by valuation (54 deals worth US$59bn), M&A decreased to 55 deals worth US$ 15.1bn - representing a 77.9% decrease by deal value.Telecommunications was the most active sector by deal value, with 3 deals valued at US$ 6.5bn - representing 43% of deals by value. Telecommunications represented 58.9% of deals by value in 2010, with three deals worth US$ 34.6bn. Consumer was the most active sector by deal count, with 15 deals worth US$ 4.8bn.

BTG Pactual and Pinheiro Neto Maintain Top Latin America Financial and Legal Advisor Rankings

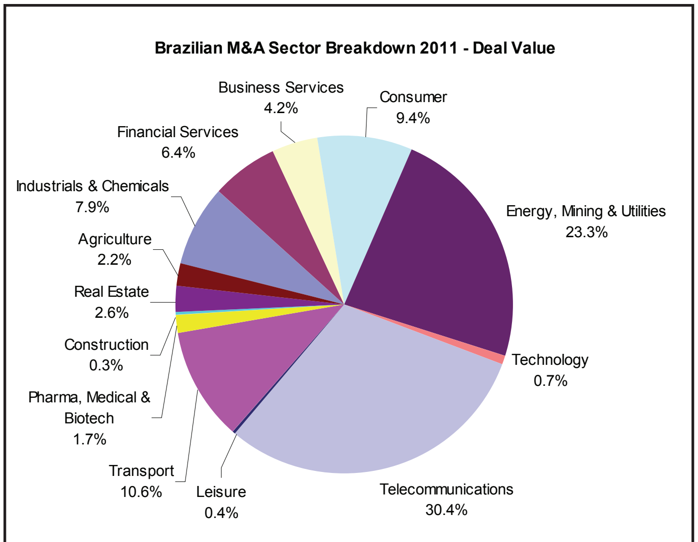
The Top financial adviser by both deal value and count was BTG Pactual with 38 transactions valued at US$ 41bn. Credit Suisse ranked second by both deal value and count, with 33 deals worth US$ 29.7bn. The top legal adviser by deal value and deal count was Pinheiro

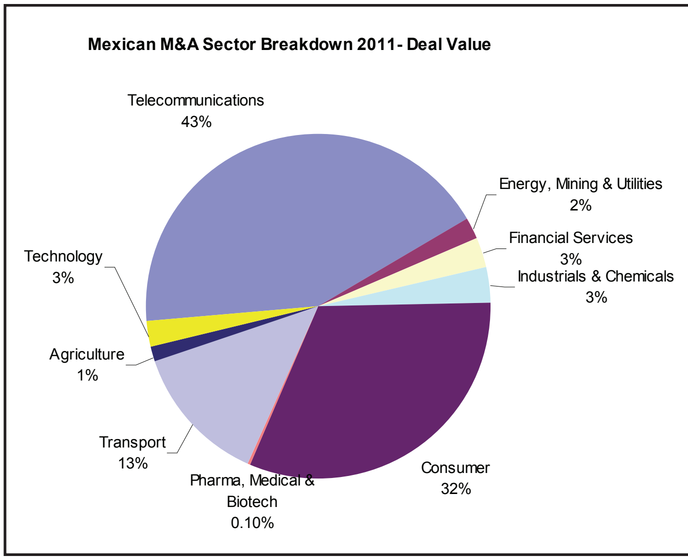


Mergermarket is an independent mergers and acquisitions intelligence service, specializing in forward-looking origination intelligence integration with a comprehensive database. (www.mergermarket.com)

Neto Advogados, which advised on 49 deals worth US$ 26.2bn. Machado Meyer Sendacz e Opice ranked second by both deal value and count, with 46 deals worth US$ 22.2bn. ❏

Sector	2011 Value ($m)	2011 mkt share	2011 Deal count	2010 Value ($m)	2010 mkt share	2010 Deal count	Change Value (%)
Energy, Mining & Utilities	19,937	23.3%	40	21,807	27.5%	37	-9%
Industrials & Chemicals	6,735	7.9%	62	13,862	17.5%	38	-51%
Telecommunications	26,049	30.4%	10	12,352	15.6%	3	111%
Financial Services	5,467	6.4%	25	9,114	11.5%	22	-40%
Business Services	3,626	4.2%	50	4,139	5.2%	39	-12%
Pharma, Medical & Biotech	1,432	1.7%	17	4,046	5.1%	21	-65%
Consumer	8,027	9.4%	53	3,145	4.0%	38	155%
Agriculture	1,848	2.2%	17	2,616	3.3%	6	-29%
Real Estate	2,227	2.6%	13	2,612	3.3%	10	-15%
Transport	9,090	10.6%	16	2,369	3.0%	11	284%
Technology	641	0.7%	12	1,308	1.7%	22	-51%
Media	0	0.0%	9	762	1.0%	7	-100%
Construction	255	0.3%	9	592	0.7%	7	-57%
Leisure	314	0.4%	6	499	0.6%	5	-37%
Defence	37	0.0%	3	0	0.0%	0	-
Total	*85,685*	100%	342	79,223	*100%*	*266*	*8%*





Mercosur Countries to Strengthen Import Substitution Measures

By Justin Miller and Staff (White & Case LLP)

From December 19-20, 2011, Mercosur countries (i.e., Argentina, Brazil, Paraguay, Uruguay and Venezuela[1]) held the XLII Mercosur Summit and Common Market Council (Consejo del Mercado Común (CMC)) meeting in Montevideo, Uruguay. At the Summit, Mercosur Leaders expressed their intention of continuing to adopt economic and trade measures to protect domestic companies from the global economic crisis. In this regard, Mercosur countries adopted a mechanism to temporarily increase their national import tariffs applicable to third countries (i.e., non-Mercosur Members), exceeding the Mercosur´s Common External Tariff (CET) but remaining below their bound tariff level at the World Trade Organization (WTO). In addition, the Presidents of the Mercosur countries expressed their concern over the state of play of the WTO Doha Round, and signed a Free Trade Agreement (FTA) with the Palestinian National Authority (PNA). At the Summit, Argentina took over Mercosur's Pro-Tempore Presidency.

We summarize below the main issues discussed at the Summit.

Mercosur's Foreign Trade Agenda

World Trade Organization (WTO) Doha Negotiations

Leaders expressed their concern in regard to the current state of play of the WTO Doha Round, and reiterated the necessity to achieve a "balanced and satisfactory" agreement, based on Doha's development mandate and the progress already achieved in the WTO Ministerial Conferences in Doha (2001) and Hong Kong (2005);

Mercosur-European Union (EU)

Leaders reiterated their willingness to continue working to reach an ambitious, comprehensive and balanced Association Agreement, which will consist of: i) a framework for political dialogue; ii) a framework for cooperation; and iii) a Free Trade Agreement (FTA). Mercosur Presidents highlighted the results of the XXII and XXIII meetings of the Mercosur-EU Bi-Regional Negotiating Committee (BNC);

Mercosur-Palestinian National Authority (PNA)

Presidents welcomed the signature of the Mercosur-PNA FTA, with the aim of: (i) eliminating barriers to trade and facilitating the movement of goods between the Parties; (ii) promoting conditions for fair competition in the free trade area; (iii) substantially increasing bilateral investment opportunities; and (iv) establishing a framework for further bilateral and multilateral cooperation to expand and enhance the benefits of the FTA. The FTA will enter into force on a bilateral basis (i.e.; between the PNA and each Mercosur country) 30 days after the depositary country (i.e.; Paraguay) has notified on the reception of the two first instruments of ratification, provided that the PNA is among the countries having deposited an instrument of ratification. For the remaining Mercosur countries, the FTA will enter into force 30 days after Paraguay has notified on the reception of each of the instruments of ratification.

The Presidents highlighted the importance of the Mercosur-Japan meeting held in December 2011, aimed at strengthening bilateral dialogue and economic relations.

Mercosur-Canada

Presidents welcomed the second Mercosur-Canada exploratory meeting, at which both sides exchanged information on the following issues: (i) expectations of the exploratory process; (ii) market access for goods (including tariff profiles); (iii) sanitary measures; (iv) technical barriers; (v) environment; (vi) investment; (vii) government procurement; and (viii) labor cooperation. Mercosur Leaders expressed the importance of this process, aimed at evaluating the possibility of launching "formal negotiations";

Mercosur-European Free Trade Association Trade (EFTA)

Mercosur Presidents welcomed the third meeting of the Mercosur-EFTA Joint Committee, held in Montevideo on September 12-13, 2011, and reiterated their willingness to continue examining possibilities for enhancing economic exchanges and cooperation ties with EFTA;

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Mercosur-Japan

The Presidents highlighted the importance of the Mercosur-Japan meeting held in December 2011, aimed at strengthening bilateral dialogue and economic relations; and

Latin America and the Caribbean

Presidents underscored the importance of Economic Complementation Agreements (ECAs) concluded with Mercosur Associated countries in the framework of the Latin America Integration Association (ALADI), asserting that these agreements boost bilateral trade and investment relations. In addition, Presidents expressed their willingness to continue deepening policy, economic and social integration with Latin American and Caribbean countries.

Mercosur's Domestic Agenda

Consolidation of the Customs Union

Leaders welcomed the twentieth anniversary of the signature of the Asuncion Treaty, which created Mercosur, and expressed their willingness to continue deepening the regional integration process across the political, economic, trade, productive, and social sectors. The Presidents noted the importance of the consolidation of the Customs Union to achieve sustainable development. In this regard, Mercosur Leaders committed to continue monitoring the implementation of the Customs Union Consolidation Program, which is comprised of a working agenda aimed at integrating actions that must be executed in order to accomplish the objectives set forth in the Asuncion Treaty;

Elimination of Double Taxation of the Common External Tariff (CET)[2]

Mercosur Presidents welcomed the progress achieved on the implementation of the first step of the mechanism for the gradual elimination of double taxation of Mercosur´s CET and the distribution of regional customs revenue, both aimed at fostering the free circulation of goods within Mercosur.[3] According to the mechanism, the Mercosur member in which the good originating from non-Mercosur countries is consumed will receive the customs revenue. In addition, Presidents highlighted the importance of the prompt entry into force of the Mercosur´s Common Customs Code (Código Aduanero del Mercosur (CAM)), a key element toward the consolidation of the Customs Union;

Global Economic Crisis

The Presidents remarked on the importance of continuing to coordinate policies with the aim of minimizing the negative effects of the global economic crisis. In this regard, Presidents welcomed the adoption of the Common Market Council (Consejo del Mercado Común (CMC)) Decision No. 39/11, which allows Mercosur countries to temporarily increase their national import tariffs (exceeding the Mercosur´s CET) to protect sensitive domestic industries. CMC Decision No. 39/11 establishes that each Mercosur country shall increase import tariffs applicable to a maximum of 100 NCM tariff headings during a 12-months period. CMC Decision No. 39/11 also establishes that Mercosur countries shall not increase their import tariffs over their WTO bound tariffs;

Investment

The Presidents reiterated the importance of negotiating a Mercosur Investment Agreement to strengthen development of their respective economies and continue consolidating the Customs Union;

The Presidents remarked on the importance of continuing to coordinate policies with the aim of minimizing the negative effects of the global economic crisis.

Government Procurement

Mercosur Presidents took note of the progress achieved toward concluding negotiations of Mercosur´s revised Government Procurement Agreement (GPA), and expressed their willingness to conclude the revision as soon as possible;

Venezuela's Accession to Mercosur

The Presidents highlighted their commitment to promptly conclude Venezuela's accession to Mercosur as a full-fledged Member, arguing that it would enhance regional integration. Mercosur signed Venezuela's Accession Protocol on July 2006, and national legislatures in Argentina, Brazil, Uruguay and Venezuela have already ratified Venezuela's membership. The Paraguayan legislature, however, continues to delay the ratification, arguing that Venezuelan President Hugo Chavez's policies do not meet Mercosur democratic standards; and

Ecuador's Accession to Mercosur

Leaders welcomed Ecuador's decision to join the Mercosur and highlighted the importance of the CMC Decision No. 38/11, which creates an Ad-Hoc Working Group to define conditions and modalities for Ecuador to adopt Mercosur´s legal framework.

Import Substitution Measures, Continued on page 10

Import Substitution Measures (from page 9)

Other Initiatives

Coordination of Macroeconomic Policies

The Presidents welcomed the meeting of Ministers of Economy and Central Banks Presidents, in which Mercosur countries achieved progress toward harmonizing methods for the collection and publication of statistics and coordination of macroeconomic policies; and

Special and Differential (S&D) Treatment

Mercosur Leaders welcomed the strengthening of the Fund for Structural Convergence (FOCEM) as a financial tool to tackle existing asymmetries across Mercosur countries and strengthen the integration process.

Outlook

Discussions over the global economic crisis and possible means to protect domestic companies dominated the Mercosur´s Summit. Leaders stressed that, in these challenging times, Mercosur countries should strengthen the Customs Union and policy coordination, as well as make use of existing WTO-consistent policy space to achieve economic and developmental objectives. Argentine Minister of Industry Debora Giorgi proposed a "more industrialized Mercosur" and mentioned that import substitution policies in the manufacturing sector will strengthen local production and complementation among Mercosur countries. Brazilian Minister of Finance Guido Mantega pointed out that tariff increases will protect industries in the region from cheaper imports, at a moment when Mercosur countries are being flooded by imported goods. However, Paraguay and Uruguay pushed for the enforcement of Mercosur´s "free circulation" principle and thus, the elimination of Argentine and Brazilian non-automatic import licenses. ❑

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1 Venezuela is still in the process of becoming a full-fledged Mercosur member. Venezuela's Accession Protocol will enter into force 30 days after Paraguay ratifies the agreement. Argentina, Brazil, Uruguay, and Venezuela have already ratified Venezuela's accession.

2 Imported goods that originate from non-Mercosur countries must pay twice the Mercosur's CET when they are imported into Mercosur and they are re-exported from one Mercosur member to another member (i.e., double taxation issue). Intra-Mercosur trade (i.e., imports originating in Mercosur) is carried out at zero tariff, subject to certain exceptions. Mercosur's CET averages 13.6 percent and ranges (with some country exceptions) from 0 to 20 percent ad valorem. On January 1, 1995, Mercosur implemented the CET with exception lists for each Mercosur member. The exceptions to the CET include sensitive items and intend to facilitate structural adjustment.

3 According to this mechanism, goods that originate from non-Mercosur countries (i.e., imported goods) will benefit from "free circulation" when they are re-exported from one Mercosur member to another member along the following parameters: i) in 2012, the mechanism will benefit imported goods that do not undergo any transformation processes in a Mercosur member; ii) in 2014, the mechanism will benefit imported goods that have been processed or worked on in a Mercosur country and that are levied with a CET between 2-4 percent; and iii) in 2019, the mechanism will benefit all remaining goods.

Private Equity Embarks on Brazil Ag Land Shopping Spree

By Elizabeth Johnson (Venture Equity Latin America)

Brazilian fund managers in 2012 will be expanding their foothold in some of the world's most promising tropical farmland, while uncertainty from government policy on foreign control of land keeps international investors on ice.

Fertile land, arguably the longest running scarce resource in human history, has an increasing presence in Brazilian private equity funds' investment portfolios.

It had also been an asset coveted by many foreign investors, including deep-pocketed Chinese players, until 2010 when the government threw up new hurdles for foreign capital directed toward productive land purchases. Brazil holds vast state-sized tracks of arable land unlike any other country in the world, which are expected to produce the food that will feed the planet's growing and increasingly middle class population over the next 40 years.

Local funds like Agrifirma are planning investments of 130 million reais in Brazil's grains frontier in the center west and Mapitoba, the name given to the expansion areas for soy, cotton and corn in the northeastern states of Maranahao, Piaui, Tocantins and Bahia.

The fund's prudent strategy is not geared toward speculative land purchases in the hopes of turning a quick buck by flipping the assets without developing them – a common practice that induced the government to issue a finding from the Attorney General in 2010 that aims to severely limit the size of farmlands foreign investors can purchase in the future.

Rather, it plans to develop underutilized, potentially productive land and pasture into state-of-the-art production assets for grains, fibers and coffee.

BTG Pactual, a local investment bank with a strong private equity division, is expanding its management of productive land, as well as investments in long under developed areas outside the farm gate, such as silos, roads, port terminals and logistics.

Demand for a better diet from the emerging markets', most notably China's, new middle class has translated into an unprecedented, concerted rise in several common agricultural commodities such as corn, soybeans, coffee, cotton, sugar, orange juice and others. This trend started prior to the 2008 financial crisis and has remained relatively consistent since. U.S. corn ethanol policy in response to the high price of oil and political instability in the Middle East has only exacerbated this trend by taking millions of tons of the grain off the supermarket shelves and pouring them into the gas tanks of American cars.

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Despite the prosperity that the high commodities prices have brought well-managed farming operations in Brazil and abroad, the global contraction of credit and subsequent (albeit, short-lived) drop-offs in demand, pushed many over-leveraged farming operations into insolvency. Brazil's sugar and ethanol industry is an excellent example. The industry is still working through a backlog of consolidation that started in 2007 and has allowed a handful of large, often foreign controlled milling groups to gobble up smaller, distressed, insolvent, and once family controlled mills.

Although Brazil's economy will likely grow at more than 3.5 percent this year with the stimulus of falling local interest rates and ample government sponsored lending, a tight global credit market will keep capital in the hands of banks and international demand from most of the world will be contained.

This pool of distressed assets in the farm sector has created attractive targets for private equity funds such as BTG Pactual, which recently acquired a nearly 11 percent stake and voting rights in Vanguarda Agro from the company's main shareholder Otavio Pivetta. BTG, in exchange, paid off an estimated roughly 100 million reais of Vanguarda's debt.

The company is one of Brazil's largest agricultural producers and farmland owners. The company's shares on the BM&Fbovespa exchange plummeted nearly 70 percent over the past 12 months, most of which in the past month, until the announcement of the BTG Pactual investment when the market drove up shares 9 percent after the news.

The entrance of BTG reinforced investor confidence in the company after abrupt swings in the company's share price followed accusations amongst its shareholders of insider trading. BTG may also opt to auction some of the shares it has acquired in the company which would give Spaniard Enrique Banuelos through his Veremonte

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Private Equity Embarks (from page 11)

investment fund a chance to expand his stake and control in Vanguarda. Veremonte left the management team of Vanguarda in December after Banuelos and Pivetta disagreed over the creation of a fund to manage the company's land assets. The market did not receive the departure of Veremonte from management well.

BTG Pactual said, however, it is not the company's objective to change the composition of management or the structure of the company. Vila Rica and Tiradentes funds, through which Veremonte has participation in Vanguarda, continue to hold a 13 percent stake in the Brazilian firm after selling down from 21 percent previously. Veremonte, however, said that it continues to hold nearly a 20 percent stake in Vanguarda through other investment vehicles and continues to hold the right to acquire an additional 5 percent of company equity, which is currently in Pivetta's hands.

Pivetta had held 27 percent of the company prior to the sale of nearly 11 percent of the company equity to BTG. This would make his control of Vanguarda more tenuous. Pivetta said, like Veremonte, that he continues to hold nearly 22 percent of the company, however, through family members and participation through other investment funds.

The allegiances of next largest shareholders in Vanguarda, Helio Seibel with nearly 11 percent and Silvio Tini with 5.5 percent, are also worth considering.

Vanguarda Agro was created in October 2010 after the publicly traded company Brasil Ecodiesel bought Pivetta's closed capital company Vanguarda do Brasil for 1.1 billion reais. Veremonte is one of Ecodiesel's principal shareholders. A year earlier, Ecodiesel bought the assets of Maeda, one of the largest grain producers in Brazil. In 2011, Vanguarda Agro planted 198 million hectares of soy, corn and cotton in the states of Mato Grosso, Bahia, Goias and Piaui.

Agrifirma

Agrifirma recently got a 130 million real injection from private equity fund BRZ Investimentos, with which it plans to expand its land and logistics assets. The company is currently focused on the frontier grain areas in the northeastern state of Bahia but is looking for targets in the center west and Mapitoba area as well.

The center west state of Mato Grosso is Brazil's biggest grain producer and has a large reserve of arable but uncultivated land. The expansion of planted area in the state has slowed over the past several years, however, due to increased pressure from environmentalists. The state borders the Amazon biom and so falls under stiffer requirements for forested set-aside. Thirty-five to fifty percent of a farmer's land must be forested in Mato Grosso depending on the region of the state, whereas only 20 percent of farms in the Mapitoba grain belt need to be forested. The obstacle to the Mapitoba farming assets is that being frontier areas, they often lack the storage and transport infrastructure found in the more traditional grain production regions, such as in Brazil's southern states.

Exiting through public share offerings is not likely to turn favorable until late 2012 at the earliest given the ongoing uncertainty generated from the European debt problems.

Agrifirma was formed in 2008 with help from foreign investors such as RIT Capital Partners and Lord Rothschild. Since its inception, the company has been committed to buying undeveloped or underutilized lands, investing in their development to turn them into productive assets, and only then selling them. Prior to BRZ's 130 million real injection through its Brasil Agronegocio fund, Agrifirma had finished developing a 6,000-hectare farm in the town of Barreiras, a well-known soy-growing region in Bahia. The farm would bring the company's portfolio of productive land under management to 63,000 hectares, which is concentrated into three clusters, all located in western Bahia. BRZ Investimentos was incubated by Brazilian private equity fund GP Investmentos, and its 840-million-real Brasil Agronegocio fund has also invested in other agricultural and forestry businesses.

BRZ, which has among its investors the main Brazilian banks and state-run pension funds, has become Agrifirma's main shareholder with its injection in the company, which has been renamed Agrifirma Brasil Agropecuaria Ltda. The old Agrifirma Brasil will continue to exist with its original investors but will be called Genagro.

The fully developed, 6,000 hectare farm in western Bahia will remain in the portfolio of Genagro, which will lease the farm to Agrifirma Brasil Agropecuaria. Genagro will also maintain stocks, cashflow and other financial assets, aside from its participation as shareholder in the new Agrifirma. Genagro will also continue to invest in the agricultural land sector. The company also continues to plan for its initial share offer on the local BM&Fbovespa exchange, which it had to postpone in 2011 due to the deteriorating market conditions at the time.

The three agricultural land clusters that Agrifirma is developing are 650 kilometers north of the federal capital Brasilia and 850 kilometers from the port of Salvador in Bahia. The properties are also 1,200 kilometers from the Amazon forest. Some of the properties will be growing coffee, which has also experienced a sharp and consistent rise in prices over the past years. Demand for the beverage remains strong and output for higher quality arabicas from Colombia and other

Central American producers has been hurt by poor weather and rising production costs in the past several crops. Brazilian washed arabicas will also become deliverable against ICE New York futures contracts for the first time in 2013.

U.S. corn stocks are at record lows and Chinese soybean imports continue to grow on an annual basis, transforming from a marginal importer only a decade ago to the world's largest buy of foreign soybeans, sucking up over 60 million tons a year or more. China is also a major buyer of cotton in recent years as its growing middle class expands its consumption habits into more bourgeoisies markets.

BRZ said it is currently seeking investments in the processed foods and fertilizer markets in Brazil.

Despite the change in its controlling structure, Agrifirma Brasil Agropecuaria has not ruled out an eventual IPO if favorable market conditions return.

After several years of historically high prices for corn and soybeans, Brazil's grain belt has begun to expand again. Drought and a steady appreciation of the real against the dollar from 2003 through 2006 heaped many producers with debt that limited their expansion, investments in technology and access to credit. But despite the 2008 financial crisis and the more recent European and U.S. sovereign debt crises, high prices have triggered expansion anew on the local grain belt.

Argentine soy and corn producers El Tejar and Los Grobo and the George Soros' Adecoagro have all entered Brazil's grain belt, with El Tejar and Los Grobo overtaking local leaders such as the Maggi family as the largest producers. Los Grobo in late 2011 had to call off its planned IPO due to deteriorating market conditions. The Argentine companies as a general rule do not buy land in Brazil but lease it, relying on their advantage of scale in trading and origination. But the recent government policy limiting foreign capital's control of Brazilian land holdings also applies to leasing agreements.

Soros' Adecoagro, which has Argentine farm and ranchland as assets too, held its IPO in the U.S. market a year ago, before market sentiment turned against offerings. Its stock has since lost about 25 percent of its initial offering price. Most publicly traded companies in Brazil saw a sharp decline in their share price over 2011.

This has created such uncertainty on the local land market that foreign agricultural investment funds and management companies have suspended tens of billions of dollars of investments. The timber and forestry sector, which requires considerable capital investments, has been particularly hard hit. The current political environment favors domestically run funds with goals of developing productive land assets.

Exiting through public share offerings is not likely to turn favorable until late 2012 at the earliest given the ongoing uncertainty generated from the European debt problems. Although Brazil's economy will likely grow at more than 3.5 percent this year with the stimulus of falling local interest rates and ample government sponsored lending, a tight global credit market will keep capital in the hands of banks and international demand from most of the world will be contained. ❑

Real Estate Sale and Lease Back Deals in Brazil

By Ana Beatriz Nunes Barbosa, Raphael Moreira Espírito Santo, and Rodrigo Castro (Campos Mello Advogados)

The Brazilian market has had an increasing number of sale and lease back deals involving real estate. This type of deal occurs when a company, the holder of certain assets, sells them to another party and leases them back (entirely or partially) from the buyer, paying a periodic payment as rent.

This type of deal has been acknowledged by the national jurisprudence for some time now.[1] Initially, the Real Estate Registry had some difficulty in understanding such transactions, confusing them with real estate leasing. Real estate leasing is a financial operation where the asset is transferred in exchange for a loan, and the property, at the end of the payment of the related value and applicable interest, is transferred to the party who was in possession of the property and obtained the loan. In this case, the ownership of the property is a guarantee to the lender[2].

In the sale and lease back, the property is, in fact, transferred to a third party with a permanent intent. A separate lease agreement is jointly signed when property is for sale. This has a tax planning reason, according to Raffaele Russo[3], for it is applicable when a company wishes to switch to leasing existing assets as a refinancing measure. This option enables the company to obtain cash by selling to a third party and then assume a rental payment for a period of time.

In Brazil, many companies that do not have as their corporate purposes real estate deals are opting to make such restructuring of their assets. However, a careful draft of the related lease agreement and registration at the Real Estate Registry Office are always recommended to assure the right of remaining in the property if it is once again sold. Such a clause is named a validity clause.

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Finally, it shall be pointed out that, as the Brazilian Lease Law has a public nature, it will apply in certain conditions whether the parties establish otherwise or not. However, there are provisions in the referring law, as the possibility of lessor, in case of change of economics, after three years of the lease, or the last adjustment to the rent negotiated by the parties to reflect the present market value, requiring a judicial increase of the rent, that should be expressly waived in such lease back agreements, due to their particular nature. [4]

1 FILHO,Elvino Silva,O Leasing Imobiliário no Registro de Imóveis, in Revista de Direito Imobiliário, vol. 15, p. 11, Jan/1985.
2 RUGGIERO, Biasi, SOUZA, José Reynaldo Peixoto de, O "Lease Back" no Registro Imobiliário, in Revista de Direito Imobiliário, vol. 13, p. 47, Jan/1984.
3 Fundamentals of International Tax Planning, IBFD Publications BV, 2007.

Brazilian Government's Legislative Agenda

By Reuters

Brazilian President Dilma Rousseff began her second year in office with a very high approval rating of 72 percent, despite an economic slowdown in Latin America's largest country.

Her 17-party coalition enjoys a large majority in Congress, though she had trouble getting bills passed in 2011, notably a proposed tax on financial transactions to pay for healthcare, a defeat that raised doubts about her government's ability to maintain fiscal discipline.

Following are the main items on the agenda this year:

New Forestry Code

Regulates the use of land and eases existing rules for minimal forest coverage on agricultural land. Environmentalists condemned the law that is supported by Brazil's farm lobby. The Senate approved it in December and it is expected to pass the lower chamber this year.

Oil Royalty Distribution Law

Hotly debated bill that would share the 10 billion reais ($5.6 billion) in royalties earned by three oil-producing states with 24 other states and the central government. It passed the Senate and could end up in the courts if the lower chamber does not approve. Rousseff has steered clear of the issue, but the government will have to get involved to avoid a loss of revenue. Lack of clarity on this issue hinders new investment in exploration. A major item given the expected bonanza from the off-shore sub-salt oil fields Brazil is developing.

World Cup and Olympics Law

Lays down the rules for holding the two global sports events in 2014 and 2016. Pending in the lower chamber of Congress. The government still has to resolve a dispute with world soccer body FIFA over Brazil's ban on alcohol drinks at stadiums. FIFA has accepted in principle Brazil's policy of half-price tickets for Brazilians over 65.

New Mining Code

Sets time limits for mining concessions to start operating and increases royalties paid by companies extracting minerals, which are considered very low at present. Has not been sent to Congress yet and not expected to be debated until second half of 2012.

Brazilian President Dilma Rousseff's 17-party coalition enjoys a large majority in Congress, though she had trouble getting bills passed in 2011, notably a proposed tax on financial transactions

Public Servants Pension Fund

Brazilian civil servants retire on full pay, a major drag on the country's fiscal accounts. This reform law would give new employees the option to switch over to private pension schemes or contribute more to a state pension. Expected to pass because it does not affect current employees' pockets and would only kick in after 2040 when new employees start retiring.

Tax Reform

A major gripe from Brazilian businessmen who complain that high taxes and poor services, port and roads make Brazil uncompetitive in a sluggish global economy. Presidential aides say comprehensive tax reform was never promised by Rousseff and is not on her agenda, but piecemeal reforms of existing taxes could be done incrementally. ❑

Brazilian Securities and Exchange Commission Issues New Rule Amendment Affecting the Ability of Mutual Funds to Invest in Brazilian Depositary Receipts:
What It Means for Brazilian Investors and Other Participants

By Tarik A. Gause (K&L Gates LLP)

The Commissão de Valores Mobiliários (the "CVM"), Brazil's Securities and Exchange Commission, adopted on December 20, 2011, Instruction No. 512,[2] a rule amendment which allows for Brazilian mutual funds to invest up to 100% of fund assets in certain Brazilian Depositary Receipts ("BDRs"). BDRs, first launched in Brazil in 2000, are the equivalent of American Depositary Receipts ("ADRs") traded in the United States and are backed by securities issued by foreign public companies.[3]

Specifically, under Instruction No. 512, if certain conditions are met, funds may invest an unlimited amount of fund assets in the so-called Unsponsored BDRs,[4] a category of BDRs issued by financial institutions rather than securities issuers directly. Under the rule amendment, funds are allowed to invest in Unsponsored BDRs in exactly the same manner that they invest in similar domestic securities. The conditions for any fund seeking to take advantage of the rule amendment are that: (i) the fund must cater exclusively to so-called "qualified investors,"[5] and (ii) the fund must use a prescribed phrase in its name to indicate that the fund will be trading securities backed by foreign equity.[6]

So, what does the Instruction No. 512 mean in practice for qualified investors in Brazil? And who else stands to benefit from its implementation? In order to appreciate fully responses to these questions, it is useful first to look at CVM's gradual liberalization of Brazil's funds sector and to note the magnitude of the Brazilian fund industry in a global context.

Gradual Regulatory Liberalization

CVM Instruction No. 409, as amended,[7] is the primary body of law regulating Brazilian investment funds, including hedge funds, and governs their establishment, administration, operation and disclosure requirements. Instruction No. 512 is one of several significant amendments to Instruction No. 409 effected by the CVM over the past several years in order to gradually grant Brazilian funds the ability to participate in the global asset market. Prior to 2007, all investment funds in Brazil were limited to investing 10% of their assets in foreign securities, with one exception.[8] However, in March and June 2007, the CVM issued rule amendments allowing multimercados, a term used to describe onshore hedge funds, to invest up to 20% of fund assets in foreign securities similar to those which such funds trade domestically.[9] In February 2008, the CVM issued what was, until adoption of Instruction No. 512, the most liberal rule amendment with respect to foreign investment. Instruction No. 465 allows funds exclusively serving clients seeking to invest at least R$1,000,000, informally known as "super-qualified" investors, to invest up to 100% of fund assets in foreign securities.[10] Such funds must also have "Investimento no Exterior," or "Foreign Investment," in their names. The main policy objective behind adopting the aforementioned rule amendments over time, rather than in more condensed timeframe, was to pace foreign investment liberalization with the CVM's ability to address investor protection concerns.

Brazilian mutual funds will have the latitude to invest more heavily in BDRs, which are a valuable asset for investors seeking greater diversification, more foreign exposure and less volatility.

Mutual Fund Industry in Brazil

The Brazilian mutual fund industry is sophisticated, tightly regulated and transparent. Currently, in Brazil there are approximately 400 fund managers registered with the CVM and supervised by the Associação Brasileira das Entidades dos Mercados Financeiro e de Capitais ("ANBIMA"), the industry's self-regulatory organization. These managers are responsible for more than 9,000 funds. According to the most recent data on registered funds from the Investment Company Institute, a national association of U.S. investment companies, the fund management industry in Brazil had assets of US$980 billion at the end of 2010, making it the sixth largest asset management market in the world, ahead of both the United Kingdom and Canada.[11] The U.S. market is the world's largest with approximately $11.8 trillion in assets.[12]

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Beneficiaries

Of course, the Brazilian qualified investor is the most obvious beneficiary of Instruction No. 512, which will enter into force on July 2, 2012. At that time, Brazilian mutual funds will have the latitude to invest more heavily in BDRs, which are a valuable asset for investors seeking greater diversification, more foreign exposure and less volatility. Furthermore, in the near future, BDRs are likely to become an even more attractive investment option as long-term inflation and rates of return on domestic investments continue to fall in Brazil.

Yet, there may be other beneficiaries. For example, the International Market segment of the Bolsa de Valores, Mercadorias e Futuros ("BM&FBOVESPA"), the second largest exchange in the Americas and where the bulk of BDRs backed by U.S. companies are traded,[13] will likely receive a boost to its liquidity because of Instruction No. 512. The recently launched BDRs segment is still very much in its incipient stage in Brazil, and there is much room for growth given the size and sophistication of the Brazilian capital markets. As the BDRs market matures, so too does the possibility of BM&FBOVESPA becoming a regional hub for such trading. Futhermore, it follows that, as demand for BDRs increases, interest from financial institutions that issue BDRs likely will increase as well. The time and transaction costs to launch a BDR in Brazil, to sell the underlying securities abroad and to transfer fund assets back to Brazil are relatively small.[14] To date, Banco Bradesco, Itaú Unibanco, Citibank and Deutsche Bank have all established a presence in this arena, each with BDRs backed by shares of foreign companies.

Fund managers stand to benefit as well. Unlimited access to foreign equity and to a broader group of investors will allow fund managers to design products and optimize investment strategies in unprecedented ways in Brazil. Moreover, it is important to note that, outside of foreign investment quotas, fund managers previously faced a number of other obstacles that Instruction No. 512 appears to mitigate. For example, foreign direct investments by funds are subject to a number of fiscal penalties, including high taxes. However, investing through BDRs circumvents this issue because such investments are treated as investments in domestic securities.

Lastly, Instruction No. 512 is an additional opportunity for foreign issuers to reach investors in Brazil's evolving economy. Increasing demand for foreign equity via BDRs will not only provide foreign issuers with greater exposure among Brazil's qualified investors, but it will also create more of an incentive for fund managers and brokers in Brazil to familiarize themselves with a larger number of foreign issuers. This would likely lead to more coverage by local corporate analysts and hopefully result in better informed investors and higher demand for exposure to foreign equity.

Conclusion

Foreign issuers, financial entities and others interested in attracting investors and pursuing opportunities in Brazil successfully should make it a priority to remain current on developments in Brazilian regulatory framework governing the mutual fund industry. ❑

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1 * Nothing in this article should be construed as containing legal advice either under the laws of Brazil or any other jurisdiction. It should not be relied upon in relation to any specific or general circumstance, and readers should consult appropriate legal counsel for advice with respect to their particular situation.
2 Instrução CVM N.º 512 (December 20, 2011).
3 The foreign companies whose securities back BDRs are limited to those based in countries who are signatories to the International Organization of Securities Commissions ("IOSCO") Multilateral Memorandum of Understanding or who otherwise have relevant bilateral agreements with Brazil.
4 "Sponsored BDRs" are issued, registered with the CVM and listed at BM&FBOVESPA by financial institutions which have been contracted by foreign companies to do so. Sponsored BDRs generally are backed by shares of foreign issuers with operations based in Brazil. "Unsponsored BDRs" are issued, registered and listed by financial institutions without the participation of the foreign companies whose shares back the BDRs. Unsponsored BDRs are backed by shares of foreign issuers with headquarters outside of Brazil.
5 Qualified investors in Brazil include: financial institutions; insurance firms and private equity firms; open and closed supplementary pension plans; natural or legal persons having financial investments of more than R$300,000 and who confirm their status as qualified investors with an executed written statement; investment funds serving qualified investors exclusively; portfolio managers and consultants authorized by the CVM, with respect to their own investments; and certain federal, state and municipal social security regimes. Since the beginning of 2011, the CVM has permitted the creation of funds investing up to 100% of assets in BDRs as long as the funds only served certain pension plans and natural and legal persons investing more than R$1,000,000, or so-called "super-qualified investors."
6 The fund must use in its name the phrase "Ações – BDR Nível 1," indicating that the fund will be purchasing BDRs on Bovespa's International Market exchange.
7 Instrução CVM N.º 409 (August 18, 2004).
8 The exception was for foreign debt funds. Other primary fund classifications in Brazil are short-term; indexed; fixed income; equity; external debt (federal bonds); and foreign exchange funds.
9 Instrução CVM N.º 450 (March 30, 2007) and Instrução CVM N.º 456 (June 22, 2007).
10 Instrução CVM N.º 465 (February 20, 2008).
11 2011 Investment Company Fact Book: A Review of Trends and Activity in the Investment Company Industry, 5th Edition. www.icifactbook.org. Luxembourg, France, Australia, and Ireland have the second, third, fourth, and fifth largest markets, respectively.
12 Id.
13 The following companies are among those that traded as Unsponsored BDRs on BM&FBOVESPA's International Market exchange as of the end of 2011: Apple, Avon, Goldman Sachs, Citibank, Google, ArcelorMittal, Walmart, Exxon Mobil, McDonald's, Pfizer, Alcoa, Cisco Systems, Citigroup, Freeport-McMoRan Copper & Gold, General Electric, Intel, Merck, Microsoft, Procter & Gamble and Wells Fargo.
14 Comissão de Valores Mobiliários (CVM) Edital De Audiência Pública SDM Nº 11/11, 9 de setembro de 2011. (CVM Solicitation for Public Comment on Instruction No. 512, dated September 9, 2011.)

Tax Treatment of Derivative Instruments in Chile

By Omar Morales (Montt & Cía.)

According to statistical data provided by the Superintendency of Banks and Financial Institutions in Chile, operations involving derivatives amounted to approximately US$9,306,500,000 in December 2010.[1] However, the development of the derivative instruments market is mixed. Certain derivatives such as forwards of US Dollars, swaps of interests rates, inflation forward and interest rate forwards are commonly used in the over the counter market, while there is no stock exchange transactions of such instruments, despite efforts by the Santiago Stock Exchange to introduce their use.[2]

Before October 22nd of 2011 there were no legal provisions dealing with the tax treatment of Derivative Instruments. On this date it was published in the Official Gazette Law Nº 20,544 ("the Act") providing rules on this matter.[3]

This article will discuss the provision of this Law after reviewing the Central Bank regulations applicable to such instruments.

Central Bank Regulations

The Central Bank has issued regulations applicable to derivative instruments. These rules are contained in Chapter III.C.2 of the Compendium of Financial Rules for operations in the domestic market[4] and in Chapter XI of the Compendium of Foreign Exchange Rules for operations with foreign markets.[5]

Derivative Instruments in the Domestic Market

These rules provide a definition of derivative instrument as "contract or agreement which financial results depend, or are subject to the variation or evolution of the price or performance of another asset or combination thereof, and is payable in the country in local currency."

These rules apply to futures, forwards, swaps and combinations thereof, on local currency or authorized adjustable units, local interest rates and fixed income instruments, held by banks established in Chile, among themselves or with third parties domiciled or resident in the country as well as futures contracts, forwards, swaps and combinations thereof, on foreign currency and foreign interest rates held by banks established in Chile, among themselves or with third parties domiciled or residents in the country.

These regulations also apply to option contracts under which the banking firms established in the country grant in favor of another party, subject to an agreed maturity date, the power to exercise a right to purchase ("Call") or sell ("put") certain financial assets (currency, interest rates, commercial or other fixed income instruments) which acquisition or disposal, as appropriate, is authorized to the issuer of the option.[6]

The development of the derivative instruments market is mixed. Certain derivatives such as forwards of US Dollars, swaps of interests rates, inflation forward and interest rate forwards are commonly used in the over the counter market, while there is no stock exchange transactions of such instruments, despite efforts by the Santiago Stock Exchange to introduce their use.

Contracts entered into by banks, whether in-or-off of a stock exchange, must be futures or forward contracts or options on currencies, authorized adjustment units, interest rates and fixed income instruments. In no case do these operations relate to shares or stock price indexes.

Contracts on derivative instruments are required to include at least the following:

i) The notional or principal amount of the operation, nominated in pesos, any authorized adjustment unit or currencies with recognized daily exchange rates;
ii) Term of the contract, indicating the start and due dates;
iii) The currency, interest rate or instrument underlying the transaction, indicating the term of that instrument and the time for recalculation of the applicable;
iv) The currency, interest rate or spot reference price which change in value will trigger the payment of the obligation of the relevant party in national currency;
v) In case of options, contracts must also provide for the term and the applicable price for the exercise of the option.

Derivative Instruments, Continued on page 18

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Derivative Instruments (from page 17)

The Superintendency of Banks and Financial Institutions is required to audit compliance with these rules and provide the regulations regarding accounting and public information that financial institutions must provide about their operations on derivatives and control procedures applicable to these contracts.

Derivative Instruments in Foreign Currency

The provision of the regulations set forth the information requirements that banking institutions have to provide to the Central Bank regarding such operations and their settlement. According to these provisions the operations must be performed in the formal exchange market (this is, through banks and financial institutions established in Chile). The information requirement affects banks established in Chile, Chilean residents conducting operations with non-residents and residents operating with the entities of the formal exchange market.

Tax Treatment

General: The Act applies to all corporate and individual taxpayers and classifies the income derived from derivative transactions as "other income" for income tax purposes.

Definition of Derivative

For purposes of the Act derivatives are considered as forwards, futures, swaps and options, and combinations of any of them, as well as "other contracts which value is set based on one or more variables that determine the amount of the related settlements, which are recognized or regulated as such in accordance with the rules issued by the Superintendency of Securities and Insurance, the Superintendency of Banks and Financial Institutions, the Superintendency of Pensions Funds or the Central Bank of Chile."

Besides the general definition, the Act sets forth a three-prong test to include, as derivatives, any transactions that meet the following requirements:

a) The value has to be set based on one or more variables that determine the amount of the respective settlements such as an interest rate, the price of another financial instrument, the price of a commodity, an exchange rate, a rate or rates of price changes, a rating or credit rating or other, provided that the respective variable is not specific to a party to the contract;
b) That do not require an initial investment or, if such investment is required, it is significantly lower than that required for a direct investment in the underlying asset or enter into other contracts or operations expected to respond similarly to changes in market variables; and
c) That the settlement occurs in a previously defined future date already established or subject to future determination.

Notwithstanding the above test, expressly excluded from the qualification as derivative for purposes of its tax treatment are the following transactions:

a) Securities lease and lending and short selling transactions on securities;
b) Instruments issued by an entity when its value is linked to its own share prices, such as subscription rights and purchase options issued for subscription by employees, except those options related to preemption rights in favor of the issuer shareholders;
c) insurance contracts governed by the General Act of Insurance Companies;

The Superintendency of Banks and Financial Institutions is required to audit compliance with these rules and provide the regulations regarding accounting and public information that financial institutions must provide about their operations on derivatives and control procedures applicable to these contracts.

d) Contracts whose value is set based on variables related to nature such as environmental, climatic, geological or the like phenomena;
e) Contracts for the sale of financial assets that require delivery of assets within the time limits established by the regulations of the markets in which the parties operate.
f) Supply contracts or rights to future services or physical assets such as energy, real property and supplies, or intangible assets such as trademarks and licenses.
g) Commitments for future loans at the market rates prevailing at the time of such operation.
h) Financial guarantees such as bonds or letters of credit, which oblige to make certain payments if the debtor's default.

Despite these express exclusions, the Act states that other transactions may also be excluded from derivative treatments without providing any further explanation.

The Act also includes a specific definition of Option as "a derivative instrument by which, for the payment of a price or a premium, its holder acquires the right, but not the obligation, to buy or sell an asset at a specified price and for an agreed period, or at a certain date. The party assuming the obligation to close the transaction if the holder exercises its right under the option, is called "issuer.""

Source Rules

According to the Act the primary source criteria of the income, including issuance fees, is the residence of the taxpayer. This also applies to branches and permanent establishments of foreign companies. Also are considered as sourced in Chile the income derived in the settlement by means of the physical delivery of shares or interests in companies organized in Chile. The Act expressly states that gains realized or accrued by a non-resident are not subject to any income tax in Chile.

Accounting Rules, Income Recognition and Deductible Expenses

Accounting Rules

Taxpayers obliged to keep accounting records are required to record these transactions at their "fair and reasonable value." Fair and reasonable value is defined in the Act as the value payable in an arm's length transaction entered into by duly informed independent parties. In the case of options this recording must take place at the end of the respective tax year, if by that time the option continues to be in place.

Income Recognition

Taxpayers not obliged to keep accounting records will recognize the gain or loss upon its realization. In the case of taxpayers obliged to keep accounting records, any positive or negative difference resulting from the recording of a derivate in accordance with its fair and reasonable value should be recognized as a gain or loss of the respective tax year. The gain or loss realized in the liquidation or assignment of a derivative contract should be recognized in the taxable year in which such liquidation or assignment takes place. In the case of options, any positive or negative difference resulting from the recording of a the option according to its fair and reasonable value should be recognized as gain or loss if the option continues to be in place at the end of the respective taxable year. The taxation of capital gains realized in the transfer of an option follows the general rules of taxation as modified by this Act.

Deduction of Expenses

In general, all expenses related to a derivative contract are deductible. In case of expenses incurred in foreign transactions, expenses are deductible provided that the following conditions are met (in addition to those conditions for deduction of expenses established in the Income Tax Act):

1. That the derivatives are not entered with counterparties or intermediaries established, domiciled or resident in countries or territories at the date of entering into or performing the respective operation, are listed as tax havens with harmful tax practices (as defined by the OECD) unless that country or territory has signed an exchange of tax information agreement with Chile;
2. The respective derivatives have been obtained through a recognized stock exchange or by over the counter transactions in accordance with standardized contract forms widely recognized.

If the above conditions are not met, these expenses will be considered as non-acceptable and will be taxed at a 35% rate.

Related parties may enter into derivative contracts provided they are arm's length. The Tax Authorities have broad authority to qualify if the transaction has legitimate business purposes.

General: Related parties may enter into derivative contracts provided they are arm's length. The Tax Authorities have broad authority to qualify if the transaction has legitimate business purposes and they are not used to disguise profit distributions or other transaction that should have been taxed in accordance with the general taxation rules. Transactions with derivative instruments shall be recorded separately and shall be subject to the information and reporting requirements to be established by the tax authorities. Taxpayers are not required to make advance monthly tax payments on the income derived from such transactions.

The Act entered into force on January 1st, 2012.

Tax Rulings

Prior to the entry into force of the Act, the Tax Authorities have issued rulings related to derivative operations.

Ruling 1211 of July 27th of 2010 states that tax stamp does not apply to derivative contracts as this tax applies to money lending operations and derivative contracts do not fall within the legal definition of such transactions.[7]

In Ruling 696 of April 11th of 2008 the Tax Authorities faced with the question whether the positive or negative results of forward operations are (or not) part of the operational income of a mining company (as defined for purposes of application of the mining royalty established in the Tax Code) concluded that such results do not form part of it. Instead, it was considered a gain or loss resulting from security transactions.[8] As a consequence, this gain or loss must be included in the general income of the taxpayer and not in the operational income of a mining company for purposes of application of operational income of a mining company.[9]

In addition to the foregoing, Resolution 114 of September 25th of 2008 exempts non-residents that obtain gains from operations with derivative instruments from

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the obligations to declare initiation of business activities and filing income tax returns.[10]

Conclusion

The Act provides for the first time special rules for the tax treatment of derivatives. In general the provisions work on the basis of realization of income and most importantly exempt from domestic income taxation foreign non-residents who enter into derivative transactions with Chilean residents. ❏

1. See www.sbif.cl/sbifweb/internet/archivos/Info_Fin_201012_1242.xls. The actual amount is CL$4,653,250,000,000. The mentioned US$ amount is considering a US$1 = CL$500. Of these operations the majority are swaps (72,98%) and forwards (26,95%) with almost nil participation of options and futures.
2. Budnevich & Asociados Final Report "Estudio de Diagnóstico, Evaluación y Propuesta de Desarrollo del Mercado de Derivados en Chile" (Diagnosis, Evaluation and Proposal of Development of the Derivatives Market in Chile), August 28, 2009. This report was prepared for the Bank and Financial Institutions Comptroller (Superintendencia de Bancos e Instituciones Financieras or "SBIF"). Document available at http://www.sbif.cl/sbifweb/servlet/Biblioteca?indice=C.D.A&idContenido=11069
3. Tax available at http://www.leychile.cl/Navegar?idNorma=1031504. Visited January 10th 2012.
4 "Transactions of Derivatives in National Currency" available at the Central Bank website http://www.bcentral.cl/normativa/normas-financieras/index.htm Visited Jan 19th, 2012.
5. "Transactions with Derivate Instruments" also available at the Central Bank website http://www.bcentral.cl/normativa/cambio-internacional/compendio-normas/index.htm. Visited Jan 19th 2012.
6. According to the regulations issued by the Central Bank, the financial institution acting as an issuer of the option concerned, must be classified at level A solvency. Entities that ceased to be classified in this level of solvency, or that in the opinion of the Superintendence of Banks and Financial Institutions present deficiencies or weaknesses in financial risk management and treasury operations, can only continue to make engaging in these operations in the conditions set by this supervisory body. Banks must also comply with the other regulations contained in the Central Bank regulations.
7. http://www.sii.cl/pagina/jurisprudencia/adminis/2010/otras/ja1211.htm.
8. The Act now states that income derived from derivative transactions are considered "other income" (See article 4).
9. http://www.sii.cl/pagina/jurisprudencia/adminis/2008/renta/ja696.htm.
10. http://www.sii.cl/documentos/resoluciones/2008/reso114.htm.

From Terrorism to Tourism: Waving the Flag of Development in Colombia

By Knowledge@Wharton and the Lauder Institute
(Wharton School of the University of Pennsylvania)

"This country has moved from terrorism to tourism," former Colombian President Alvaro Uribe told delegates at the United Nations World Tourism Organization gathered in Cartagena for their General Assembly in December 2007.

Colombia's history has been plagued by violence, corruption and crime, an image that has been readily apparent to the outside world due to media depictions and worldwide travel warnings. Guerilla fighters and drug kingpins rivaled the government in political and economic power well into the 1990s. However, the death of Pablo Escobar in the mid-1990s and President Uribe's implementation of a comprehensive security strategy in the mid-2000s significantly weakened illegal armed groups.

As a direct result of the increase in safety and stability accomplished by the Uribe administration between 2002 and 2010, Colombia has become a destination accessible to more than just a select group of intrepid business travelers and vacationers. The country is a natural magnet for visitors, boasting richness in both cultural diversity and biodiversity. It is home to eight UNESCO World Heritage sights and is quickly becoming known for its culture and history. Bordered by two oceans, it has three mountain ranges in addition to jungle and plains regions. The country's cultural diversity is reflected in its heterogeneous roots -- mainly, indigenous, European and African. Diversity is also found in its rich urban centers, which thrive on business, commerce, and cultural activities as well as a vibrant nightlife. The largest of these urban centers, Bogotá, is currently the sixth most-visited city in Latin America and 47th worldwide.

Having only recently been a fledgling industry, tourism in Colombia is now thriving. In 2011, the tourism sector is expected to contribute 28 trillion pesos (US$15.7 billion) to GDP (4.9%), 945,000 jobs (5.4% of total employment), and 7.1 trillion pesos (US$4 billion) in capital investment. Foreign travelers' visits to Colombia rose from 0.6 million in 2000 to nearly 1.4 million in 2009, reflecting an average annual growth rate of more than 10% (almost four times the world's average). These recent years of growth have shaped political decision making and allowed the government to recognize tourism as a promising avenue for future economic development. Tourism has also greatly influenced the political, social and commercial environments in which Colombians live, and will continue to have important implications in these areas.

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Positioning for Growth

In 2005, a multidimensional international marketing campaign, "Colombia Is Passion," was launched to foster the expansion of tourism in Colombia. The movement aims to improve the country's image abroad while also rebuilding morale among its citizens. This campaign, a cooperative effort between the Ministry of Commerce, Industry, and Tourism and public and private institutions, invites airline representatives, tourism-agency executives, politicians, celebrities and international media figures to see Colombia's tourist attractions and recent achievements in safety, foreign direct investment and economic development. Funding has also been used to propagate the new official slogan: "Colombia, the only risk is wanting to stay." This is an ongoing project with many successes realized thus far, including the inauguration of the coastal town of Cartagena as host of the World Tourism Organization's 2007 convention. Furthermore, since the campaign's launch, Colombia has hosted a number of other fairs and trade shows of international prestige.

The country's appeal to potential investors is strengthened further by government investment in infrastructure. For many years, commerce in Colombia had been hindered by its out-of-date transportation network (in addition to the previously mentioned

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security issues). With three mountain ranges dividing the country's most populated regions and a weak network of roads and rail links, the movement of goods had always been time-consuming and costly. The government's renewed focus on infrastructure investment not only benefits tourism, but also improves transportation costs for unrelated sectors.

Plans to upgrade seven airports throughout the country are underway, including the current expansion of the international airport in Bogotá, which will make it one of the largest and most modern in Latin America. Since 2000, international flights to Colombia have increased by 120%, reaching an average of 5,600 flights per month as of 2008. Roberto Jungito, CEO of Copa Colombia, described the surge in tourism as a virtuous cycle: Improvements in Colombia's image and security measures have increased the demand for flights, which has in turn increased supply, resulting in more competitive prices and an augmentation of air traffic. In addition, the 2011 Open Skies air-transport agreement between Colombia and the U.S. increases the number of passenger and cargo flights and spurs price competition among airlines.

Recent initiatives aimed at supporting broader infrastructure in the tourism industry have also been announced. For example, in September 2010, President Juan Manuel Santos introduced a 118 billion pesos (US$66 million) plan directed toward projects that benefit the construction and expansion of shipping docks and convention centers throughout the nation.

In hopes of boosting private investments in the hotel sector, the government began a program in 2003 that offers a 30-year income tax break on all construction or remodeling projects through 2018. By 2006, this had led to the addition of more than 7,300 hotel rooms and more than 152 billion pesos (US$85 million) in investment. The government also recently cooperated with the private sector to change legislation and allow the formation of Real Estate Investment Trusts (REITs), investment vehicles that facilitate the flow of foreign capital into real estate development and management. José Robledo, founder of Terranum, Colombia's first REIT, states that "The regulatory process to launch the REIT was quite complex. However, we managed to achieve a very robust structure because government officials understood the advantages that this type of financial vehicle offered for the development of the country's capital markets. Even so, I believe it was still unclear to them how this type of vehicle could bring benefits specifically to the tourism and hotel sector." These benefits can be seen today, as Terranum is currently in the construction phase of several hotel projects that are financed via international parties. By allowing the formation of REITs, the government made it easier for outside institutions to finance and participate in the country's growth.

Ripples Throughout the Economy

Due to sustained political support for the tourism industry and improvements in safety, tourism has become one of the most important sectors of economic activity in Colombia. The country receives billions of dollars in foreign exchange through tourism each year, making it the third most important sector by this measure, behind oil and coal. As President Santos noted in an announcement at the 2010 Celebration of Tourism Day in Bogotá, "tourism's importance in generating hard currency inflows necessitates continuation of the government's policy of growth in tourism."

Due to sustained political support for the tourism industry and improvements in safety, tourism has become one of the most important sectors of economic activity in Colombia.

Tourism has generated strong economic growth in Colombia, which, in turn, is attracting an increasing number of investors in other sectors from around the world. The effect of Colombia's drastically improved international reputation, while all but impossible to quantify, is difficult to refute. Net foreign direct investment has peaked in recent years, during which it has averaged approximately 16 trillion pesos (US$9 billion), or about 4% of GDP. Businesses within the tourism industry and related supporting sectors, such as restaurants and retailers, tend to be labor intensive. As a result, foreign investment in tourism has helped reduce the country's unemployment rate, which fell from nearly 20% in the early 2000s to about 12% in recent years. Even though profits from tourism-related investments are repatriated elsewhere, a great deal of money stays within the country due to requirements that the vast majority of all employees and managers be of Colombian citizenship.

Job creation is partly a result of Colombia's legal stability contracts and free trade zones, mechanisms that the Colombian government created to generate favorable conditions for both domestic and foreign investors. Legal stability contracts are a unique tool used to boost investor protection against political risk by guaranteeing that changes to legislation will not adversely affect the profitability of a particular investment. Furthermore, within Latin America, Colombia has some of the most competitive free trade zones. While companies in these zones reap benefits, such as a 15% corporate income tax rate and no customs tax on imports, companies must also meet both investment and job-creation requirements.

Colombia's recent improvement in its macroeconomic performance, internal security and stability for business means more jobs and opportunities. The creation of employment, in particular, has impacted popular vacation destinations, such as Cartagena, which comprises a large Afro-Colombian population living under the poverty line. Tourism will continue to be a factor in reducing unemployment, as illustrated by President Santos' announcement in 2011 that the national government seeks to create 250,000 jobs in the tourism sector over the next four years.

The growing tourism sector has both created new employment opportunities for locals and influenced migration to tourist-heavy cities, such as Bogotá, Cartagena and Medellin. As has been seen in other developing countries, urbanization results in the creation of new types of employment for individuals previously outside the labor force, such as women. Minister Luis Plata, in an interview with the BBC, stated that "tourism demands a lot of labor and not necessarily the most qualified labor. It has tremendous social impact," given its effectiveness in fighting poverty.

The government, however, has identified the need for social and education programs to support the increased demand for labor -- both skilled and unskilled. In 2006, the Ministry of National Education financed the Caribbean Colombian Alliance, which aims to improve education in the coastal region in order to support technical and technological training for employment in tourism and eco-tourism. Colombian higher education institutions have partnered with foundations and trade unions, local communities and the private sector to accomplish specific goals. These goals include increasing matriculation by 30,000 students, redesigning competency-based curricula to ensure alignment with those skills relevant to the tourism sector and improving educational infrastructure. Within three years, 1,500 young adults received technical training in Cartagena and now have the competencies and skills necessary to work in tourism. There are also expected to be an additional 600-plus graduates per year in the technology space. Germán Bula Escobar, former minister of National Education, praises the success of this type of initiative. "The government supports universities and the productive sector," he notes. "It is these successes that will drive [us] to continue to support these types of alliances that benefit both education and business."

Tourism has served as a tool for sustainable social development in Colombia. The training has led Colombia to achieve levels of human capital comparable to those found in other well-developed nations. According to the 2009 IMD World Competitiveness Yearbook, Colombian labor relations are the best in the region, and the labor force is qualified at levels similar to those of Italy and the United Kingdom. This strength, developed through linkages between the private and public sectors, will serve as a strong foundation for growth as other areas of tourism are developed, and they continue to realize additional positive social impacts.

Although Colombia's progress in combating its global reputation issues is impressive, the country's image is still marred by its history of violence -- one of the greatest impediments to its growth.

Positive Feedback

Colombia is now on the world stage, and the stakes have been raised. The ever-increasing importance of tourism to the country's economy places added pressure on the government to continue its multifaceted approach to support this growing sector. This includes not only maintaining a harsh stance against violence, but also continuing the government's policy of identifying and eradicating fraud and corruption. A cautionary note can be taken from recent developments in Mexico, which ranks 10th on the list of most-visited countries worldwide and whose tourism sector comprises approximately one-tenth of its economy. In contrast to the new growth Colombia is experiencing as it emerges from an era of violence, tourism in Mexico is being threatened by a recent surge of drug-related organized crime. Local businesses have resorted to cutting prices in order to prop up demand, which still has not returned to the levels seen in 2008. Colombia's tourism industry is less mature and only a quarter the size of Mexico's, which means it would be even less resilient to government missteps in maintaining security and stability.

Sound economic decision-making will also be critical. To date, the Colombian government has facilitated policies that have led to rapid growth in tourism. However, tax and investment incentives will eventually expire, implying that the industry must become less reliant on such measures to attract investment in the long term.

Although Colombia's progress in combating its global reputation issues is impressive, the country's image is still marred by its history of violence -- one of the greatest impediments to its growth. Catalina Crane, advisor to President Santos in public and private investment affairs, recognizes the importance of security for the future of tourism in the country when she states that "we need to promote the tourism sector, and as such, security remains the most important factor." ❏

VAT on Virtual Export/Import Transactions (V5s)

By Jaime González Béndiksen (BendiksenLaw)

Maquila operations were established in the mid-60s. They were originally devised as in-bond operations, where the Mexican maquiladora imports materials and components on a temporary basis, transforms them and then exports the finished product.

As global trading increased, the Mexican market developed a need for the products manufactured by maquiladoras. Under the original rules, the production had to necessarily be exported and then sold to the Mexican purchaser, who had to import it into Mexico just as in any other international sale.

In order to facilitate these transactions, customs rules were enacted, that allows the nonresident owner of the production to sell the goods to residents of Mexico under virtual customs transactions, where the maquiladora files a virtual export manifest ("pedimento") and the Mexican purchaser files a virtual import pedimento. These are known as V5 transactions.

Until recently, this was a very smooth procedure, where the nonresident seller would issue is normal foreign invoice and the Mexican importer would use that invoice as support to deduct the cost of goods sold. VAT was paid when importing the goods, and the Mexican importer would credit the VAT.

The story is changing with administrative rules issued beginning in June of last year.

This article will briefly discuss VAT taxation and related tax obligations, the new rules issued, how they impact nonresident sellers and Mexican importers, and the legal and practical approach that sellers and buyers may follow.

Transactions Subject to VAT

VAT levies the following events:

- Sales made in Mexico.
- Services rendered in Mexico.
- Temporary use or enjoyment of property in Mexico.
- Imports into Mexico.

Sales are deemed made in Mexico when the goods sold are in Mexico at the time they are shipped to the buyer or, where there is no shipment, when physical delivery takes place in Mexico.

Importations refers to the definitive importations defined as such by the Customs Code. Temporary importations are not subject to VAT.

The new administrative rules create burdensome obligations for both nonresident sellers and Mexican purchasers/importers.

Exports

VAT is an indirect tax, a consumption tax. It is to be borne by the end consumer. Thus, it is an internationally accepted principle that VAT should not levy exports, because the goods exported will be consumed in another country, not in the export country. And this is why, on the other hand, imports are subject to VAT.

Consistent with this principle, Mexico applies a 0% VAT rate to sales of goods by residents of Mexico, which are exported. No similar rule exists for exports in general by nonresidents.

Further, as a result of client's needs, the writer devised the idea, and lobbying efforts were pursued, which resulted in an exemption for drop shipments into Mexico of good temporarily imported, but only for sales between nonresidents or between a nonresident and a Mexican maquiladora or similar entity, provided the goods sold are exported or remain in Mexico under temporary importation.

This rule, however, does not apply to sales by nonresidents to regular Mexican entities through virtual exports/imports.

The New Administrative Rules

On June 29, 2011, the Mexican Tax Administration issued an administrative rule, Rule 3.8.4 (VI), which came into effect on December 1, 2011, to the effect that sales by nonresidents to Mexican regular resident entities are deemed sales made in Mexico pursuant to Article 10 of the VAT Law and, consequently, that the Mexican purchaser must withhold the applicable VAT pursuant to Article 1-A (III) of the law.

This rule was replaced by Rule 3.8.9 (IX) (a), with identical substance, which came into effect on January 2, 2012.

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VAT Obligations for the Sellers

If one is to take the position that both of the above rules are legal and binding, and thus wish to properly comply with the rules, then there are a number of resulting obligations.

The rules are saying that the sales in question are made in Mexico. If this is correct, then the nonresident seller is a VAT taxpayer.

VAT taxpayers have the following obligations:

a. To register in Mexico for VAT purposes.
b. To carry Mexican books for VAT purposes.
c. To issue invoices complying with all tax requirements, including itemizing the corresponding VAT. These invoices must be delivered to the purchaser within 15 days from the date the corresponding VAT was payable.
d. When VAT is withheld by the purchaser, the seller must insert the following language in the invoice: "Impuesto retenido de conformidad con la Ley del Impuesto al Valor Agregado." This language means: tax withheld in accordance with the Value Added Tax law.
e. When the VAT is withheld, the seller must state the amount of VAT withheld as a separate line item.
f. To file monthly value added tax returns, paying in the corresponding VAT, not later than the 17th day of the month immediately following the month when VAT was paid or collected by the seller.

The law provides that VAT is to be withheld when purchasing vatable goods from nonresidents. It also expressly provides that the entity withholding the VAT substitutes for the seller in the obligation to pay in to the tax administration the corresponding VAT.[1] That is, it only substitutes for the payment obligation in f. above. The obligation of the nonresident to file tax returns –and, for that matter, all other obligations- are not substituted and, thus, remain.

Now, another administrative rule was enacted, which came into effect on January 1, 2012, providing that Mexican taxpayers may claim deductions and credit input VAT documented with invoices issued by nonresidents with no permanent establishment in Mexico, provided the invoices include the following information:

a. Name, address and foreign taxpayer or equivalent id number of the entity issuing the invoice.
b. Place and date of issue.
c. Mexican taxpayer id number (RFC) of the person to whom the invoice is issued.
d. The amount, measure unit, and type of goods or merchandise.
e. Unitary value, in numbers
f. Total value, in numbers or letters, as follows:

- If payment is made in full, the invoice must so state, also indicating the total value of the transaction, itemizing the VAT corresponding to different tax rates, where applicable, and also the amount of VAT withheld.
- When payment is made in installments, an invoice must be issued, for the full amount of the transaction, expressly stating the fact that payment is to be in installments. Additional invoices should be issued for each installment meeting the prescribed requirements, and referring to the date and number of the invoice issued for the full amount of the transaction, the total value of the transaction, the amount of the installment to which this invoice pertains, the amount of VAT withheld and of the VAT shifted to the purchaser, itemizing the VAT corresponding to different tax rates, where applicable.

As can be seen, the above rule simply refers to the invoice to be issued by the nonresident. That is, the rule simply substitutes for the obligation mentioned in c. above.

VAT is an indirect tax, a consumption tax. It is to be borne by the end consumer. Thus, it is an internationally accepted principle that VAT should not levy exports, because the goods exported will be consumed in another country, not in the export country. And this is why, on the other hand, imports are subject to VAT.

Based on the above, in summary the nonresident sellers must comply with the following VAT obligations:

a. To register in Mexico for VAT purposes.
b. To carry Mexican books for VAT purposes.
c. To issue invoices complying with the requirements in the administrative rule mentioned above. These invoices must be delivered to the purchaser within 15 days from the date the corresponding VAT was payable.
d. To insert the following language in the invoice: "Impuesto retenido de conformidad con la Ley del Impuesto al Valor Agregado."
e. To file monthly value added tax returns, not later than the 17th day of the month immediately following the month when VAT was paid and withheld by the purchaser.

VAT Obligations for the Mexican Purchasers/Importers

Also on the basis that the abovementioned rules are

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legal and binding, from the perspective of the Mexican purchaser the following obligations exist:

a. Demand invoices meeting all tax requirements and itemizing the corresponding VAT, in order to be entitled to claim a deduction of the price supported by the invoice and to credit the VAT itemized in the invoice and paid.
b. Withhold the VAT itemized in the invoice when paying the corresponding price.
c. Pay in to the tax administration the tax withheld in the tax return to be filed no later than the 17th day of the month immediately following the date when the tax was withheld.
d. Issue certifications with respect to the VAT withheld, upon receiving the corresponding invoice.
e. File monthly information tax returns regarding the entities to whom VAT has been withheld, no later that by the 17th day of the month immediately following the date when the tax was withheld.
f. File a notice with the tax administration, within 30 days from the date they first withhold VAT, to the effect that they will be making regular VAT withholdings.
g. File monthly tax returns with the tax administration, regarding payments made to its suppliers, VAT withheld, VAT credited and VAT shifted by or to the taxpayer, itemizing the VAT depending on the different VAT rates that may be applicable. This return must be filed within 30 days from the date to which the information pertains.
h. Credit the VAT paid, in the VAT returning corresponding to the month next following the month in which the VAT withheld was paid in.

As mentioned above, the new miscellaneous rule regarding invoices provides that the Mexican purchaser may claim a deduction and credit input VAT paid to nonresidents without a permanent establishment in Mexico, provided the invoices meet the requirements mentioned in such item. This invoice substitutes for the obligation mentioned in a. above. All other obligations remain in place.

Constitutional Issues

In the writer's opinion, the administrative rules we are discussing are unconstitutional.

There is a Constitutional principle to the effect that taxes must be proportional to the taxpayer's wealth. Taxing a taxpayer twice, on the sale economic transaction, is certainly not proportional. Tax should be applied once only.

Given that both sales and imports are subject to VAT, the issue at hand is which of those transactions should be levied. Under Mexico's cannons of construction, where two rules of law might be applicable, the special rule prevails over the general rule. It is not always simple to determine which of the rules is the special rule. In this case, both, the rules taxing sales and taxing imports would appear to be equally general or special. However, Mexican law expressly requires VAT to be paid upon importation, at the customshouse. If VAT is not paid at the time of importation, the import manifest cannot be processed and thus importation cannot be completed. It would thus appear to your author that the special rule, the rule that should prevail, is the rule requiring VAT to be paid upon importation, and not the rule calling for VAT on sales made in Mexico.

Mexico applies a 0% VAT rate to sales of goods by residents of Mexico, which are exported. No similar rule exists for exports in general by nonresidents.

Further, the production being sold is in Mexico under temporary importation. The law provides that they must be necessarily be exported (and they will, in the transactions we are referring to). Consequently, from a customs and VAT standpoints, the goods should not be considered to be in Mexico. Therefore, the sales we are discussing should not be characterized as sales in Mexico as defined by the VAT law and, as a result, they should not be subject to VAT. This interpretation has already been confirmed by our Tax Court in one case. Note that the fact that administrative rules define the transactions as subject to VAT is not relevant, because administrative rules, by definition, cannot impose upon taxpayers obligations which are not already set forth in the law. By being contrary to the law, the rules are unconstitutional.

Taxpayers who believe that their Constitutional rights are being infringed by administrative rules may file an action for Constitutional relief, known as "amparo". The actions are to be brought within 15 work days from the date the rule is first applied to the specific case of the taxpayer. This is the case, for example, when the taxpayer begins to comply with the rule in question. Any favorable decision by the court benefits the individual taxpayer only, not any other taxpayers in similar situations.

Practical Considerations

From both a legal and practical standpoints, the nonresident sellers and the Mexican importers dealing with these virtual transactions may opt for any of the following actions:

1. Both the nonresident seller and the Mexican importers would comply with the rules, with no additional action on their part.

2. Both the nonresident seller and the Mexican importers would comply with the rules, but each would file an amparo action seeking for the rules to be declared unconstitutional and unenforceable in their specific case.
3. Both the nonresident seller and the Mexican importers would comply with the rules. Only the Mexican importer would file an amparo action seeking for the rules to be declared unconstitutional and unenforceable in its specific case. If successful, the nonresident seller would rely on the non-binding precedent, discontinue complying with the rules, and invoke the precedent in case the tax administration demands compliance with the rules.
4. Only the Mexican importer would comply with the rules. It would file an amparo action seeking for the rules to be declared unconstitutional and unenforceable in its specific case. If successful, the nonresident seller would rely on the non-binding precedents, discontinue complying with the rules, and invoke the precedent in case the tax administration demands compliance with the rules.
5. Neither the nonresident seller nor the Mexican importer would comply with the rules. The Mexican importer would file an amparo action seeking for the rules to be declared unconstitutional and unenforceable in its specific case. If successful, the nonresident seller would rely on the non-binding precedents and invoke the precedent in case the tax administration demands compliance with the rules. The downside here is that deduction of the purchases and credit of the input VAT by the Mexican importer could be at risk and may, conceivably, have to be discussed before the courts if challenged by the tax administration.
6. Neither the nonresident seller nor the Mexican importer complies with the rules. No amparo action is filed until such time as the tax administration demands compliance with the rules and related obligations. Again, the downside is that deduction of the purchases and credit of the input VAT by the Mexican importer could be at risk and would have to be discussed before the courts if challenged by the tax administration.

Conclusion

The new administrative rules create burdensome obligations for both the nonresident sellers and the Mexican purchasers/importers. The rules are unconstitutional. As such, they may be challenged through amparo actions. Each individual taxpayer must file an individual action if formal relief is desired, as decisions issued for one taxpayer do not benefit anybody else. ❑

1. VATL, Article 1-A.

Tax Incentives For Mexican Entities Investing in Real Estate Property- "Sociedades de Inversión en Bienes Raíces" or "SIBRAS"

By Agustín Mercado and Juan Carlos Silva
(PricewaterhouseCoopers Mexico)

As part of a national economic plan to increase and promote real estate investments within Mexico, in 2004, the Mexican Government put into effect an important tax incentive for Mexican trusts investing in real estate, Mexican REITS – known as "Fideicomisos de Inversión en Bienes Raíces"or "FIBRAS". Specific rules and conditions were established to apply such a tax incentive. In 2006, the tax incentive, with certain specific peculiarities, was also considered for Mexican entities investing in real estate, known as "SIBRAS". FIBRAS and SIBRAS could result into an attractive form of real estate investment in Mexico, either for domestic or foreign investors.

This article summarizes the main benefits of this tax incentive, considering that the investment in real estate is being done through a SIBRA.

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General Rules

The Mexican Income Tax Law (MITL) provides specific tax incentives for SIBRAS that qualify as Mexican residents for tax purposes, which are generally structured as any other regular business entity in Mexico, such as:

- Sociedad Anónima (SA),
- Sociedad de Responsabilidad Limitada (S. de R.L.) or,
- Sociedad Anónima Promotora de Inversiones (SAPI)

This form of investment vehicle provides flexibility for all kinds of investors, as they could be both domestic and foreign investors.

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SIBRAS are required to have as its main business activity:

(i) The acquisition or construction of real estate property intended for lease;

(ii) The acquisition of the right to obtain income arising from the lease of such assets; or

(iii) The grant of financing for purposes of the activities (i) and/or (ii) referred to above, with the assets so leased serving as guarantee.

At least 70% of the SIBRAS's wealth has to be invested in real estate property, or in the rights or on the financing activities referred to above; and the remaining percentage be invested in Federal Government securities registered in the National Securities Registry or in shares of debt-instrument investment funds.

Furthermore, the real estate property to be built or acquired has to be intended for lease and cannot be sold prior to the lapse of at least four (4) years starting from the end of construction or the date of acquisition, respectively. Real estate property alienated prior to that four-year period shall not be subject to the tax benefits mentioned ahead.

Tax Incentives for SIBRAS

Income Tax Deferral

One of the main tax benefits is that investors are allowed to defer the potential income tax on the taxable gain arising from the contribution of real estate property to a SIBRA, until they sell their participation in the SIBRA, or when the SIBRA sells the contributed real estate properties.

Advance Payments

Another tax benefit is that according to our domestic legislation and rules, SIBRAS are not obligated to determine and remit income tax and flat tax monthly advanced payments, being obligated to pay those taxes only on an annual basis.

Foreign Pension and Retirement Funds

Foreign pension and retirement funds, which are income tax exempt in their home country, investing in a Mexican SIBRA, would receive a tax credit calculated following certain criteria (mentioned ahead). Such tax credit should be delivered by the SIBRA in the following two (2) months after the year-end closing. The Mexican entity (i.e. SIBRA) would be entitled to reduce its annual tax liability with a similar amount delivered to such pension and retirement funds.

Tax Overview for SIBRAS

Income Tax Treatment

SIBRAS are obligated to pay taxes in Mexico as any other regular corporation. Given the nature of the SIBRAS, taxable income to be recognized in a certain year would generally be linked to the alienation or leasing of real estate property and interests arising from governmental securities and from investments in debt-instruments investment funds; while their deductible expenses should be linked to any of these activities.

Taxable income for SIBRAS shall be considered as such:

- Upon collection or delivery of the real estate,
- When the payments become due or,
- Upon the issuance of the corresponding invoice, whichever occurs first.

SIBRAS could be a suitable investment vehicle to set up an efficient and attractive real estate business structure in Mexico from a tax and business standpoints.

On the other hand, SIBRAS are allowed to deduct the contributed real estate assets via depreciation (e.g., buildings at the maximum annual rate of 5%).

SIBRAS must determine their annual taxable profit, which is the difference between taxable income and authorized deductions. In the case those deductions are higher than the taxable income, the tax loss arising under this scenario could be amortized against taxable profit of the following ten (10) fiscal years.

Flat Tax

SIBRAS are subject to the Mexican flat tax at the rate of 17.5% upon income arising from the alienation of assets and the leasing of real estate property. Please note that income arising from interests payments would not be subject to flat tax.

Regarding authorized deductions, SIBRAS are allowed to deduct payments for the acquisitions of goods, services received and for the temporary use of goods. Bear in mind that neither interest payments nor salaries and social security contributions are deductible for flat tax purposes. As mentioned, SIBRAS are not obligated to determine and remit flat tax monthly advanced payments.

Value Added Tax (VAT)

SIBRAS are subject to VAT upon the alienation of real estate property and upon the leasing of these assets (except leasing of habitation uses), at the general rate of 16% (11% in the border zone only in certain cases).

The alienation of land is not subject to VAT.

Real Estate Acquisition Tax

This is a tax burden for the acquirers of real estate assets, and the applicable rates range between 1% and 5%, depending on the local legislation of the State in which the real estate asset is located. In general, the basis for this tax is the higher between the value upon appraisal and the fair market value of the corresponding asset. This acquisition tax is applicable also in the case the real estate assets were contributed by the owner of them to a SIBRA.

Tax Overview for the Investors

For Mexican Tax Residents

Mexican individuals are obligated to consider as taxable income, dividends paid by the SIBRA upon actual distribution. They would be allowed to offset the corresponding income tax paid by the SIBRA. In the case of Mexican corporations, they are not obligated to consider dividends paid by the SIBRA as taxable income.

Regarding pension and retirement funds acting as investors on a SIBRA, the latter would be obligated to deliver a tax credit to these investors, within the following two months after the closing of the fiscal year. Such tax credit equal to the amount arising from multiplying the SIBRA annual income tax by the average daily ownership interest maintained by such funds during the fiscal year or by the ownership interest at the end of the fiscal year, whichever is lower.

For Foreign Tax Residents

Dividends paid by the SIBRAS are not subject to Mexican withholding tax. As in the case of Mexican pension and retirement funds acting as investors on a SIBRA, the latter would be obligated to deliver a tax credit to this type of foreign funds, as described in the preceding section.

Capital Gains

Mexican Tax Residents

In the case of Mexican individuals transferring SIBRA's shares, the potential capital gain would be subject to income tax in Mexico based upon the applicable progressive tax rate (maximum rate of 30%). The tax is determined upon the difference between the transfer value (i.e., fair market value) and the tax basis on the shares.

If the transferor is a Mexican entity, the tax would be computed at a 30% rate upon the taxable gain determined as described above.

Foreign Tax Residents

Taxable income arising from the alienation of shares on the SIBRA would be income tax exempt, to the extent they are publicly traded shares and are transferred through recognized markets, as defined with the MITL. Certain requirements must be met to have this exemption available.

In the case of publicly traded SIBRA's shares that are not tax exempt under the MITL, the foreign resident would be subject to Mexican income tax at the rate of 5% upon gross proceeds; however, they may elect to pay said tax at the rate of 20% upon net gain. In either case, the financial intermediate would be obligated to withhold the corresponding income tax.

Regarding non-publicly traded shares, the foreign resident would be subject to tax in Mexico at the rate of 25% on gross proceeds or it can elect to pay the tax at the rate of 30% on net gain, to the extent certain pre-closing requirements are met.

It is worth considering if the foreign resident resides in a country with which Mexico has in force a Tax Treaty to avoid double taxation, as they could claim the tax benefits contained therein (i.e., income tax rate reduction or income tax exemption, depending on the specific case at hand).

Final Remarks

SIBRAS could be a suitable investment vehicle to set up an efficient and attractive real estate business structure in Mexico from a tax and business standpoints. SIBRAS provide flexibility on the ownership interests (i.e., Mexican and foreign investors) and material tax incentives for both, investors and the SIBRA itself, as it has been described along this article. ❑

Intellectual Property - An Asset to its Owners

By Antonio Campero (Cacheaux, Cavazos & Newton, L.L.P.)

It is well known that companies invest in technological development and the result is inventions subject to protection by the Intellectual Property Law. Consequently, they have a competitive advantage as a result of the exclusive right to use such inventions. In the same manner, those companies that develop and properly register distinctive marks or symbols are at a significant advantage, especially when such are highly regarded by consumers. Furthermore, those with copyrights also obtain legal competitive advantages.

However, on many occasions, in an accounting context, the true value of intellectual property rights is not recognized. On occasion, the value of intellectual property rights can be greater than that of all other assets of the company. Knowing and adequately determining the value of intellectual property rights is important, especially when intending to carry out a sale, purchase, merger or divestiture of a company, or when intending to use such as a security.

Mexican law contemplates the possibility that intellectual property rights may be subject to attachment or that they may be granted as guaranties for loans, thus allowing companies to obtain credit by guarantying payment with these rights, as is customary in other parts of the world (in a well known case, David Bowie obtained a multi-million dollar credit line guaranteed by the payment of royalties to be generated by his music). In the same manner, many foreign companies that do not have any assets in Mexico, but have registered intellectual property rights, are always subject to attachment of these rights (at least as to their use in Mexico). Once again, this bears on the importance for owners of these rights to always be aware of the value of their assets, including those of an intellectual property nature. ❏

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Venezuela Gas Deal to Boost Local Power Generation

By Reuters

As gas prices plunge to their lowest for a decade, Venezuela will pay to tap one of Latin America's biggest fields wanting to boost power generation and even help revive stagnant oil production.

Venezuela, where President Hugo Chavez has nationalized almost all the oil industry, is in the top 10 nations in terms of gas reserves, but has yet to begin any commercial production. Instead, it imports supplies from neighboring Colombia.

That could finally change after Italy's ENI (ENI.MI) and Spain's Repsol (REP.MC) signed a deal with state oil company PDVSA on December 23 to develop the Perla field, where the Europeans have certified more than 15 trillion cubic feet (tcf).

The fiery leftist Chavez, who will seek re-election in October, underlined his determination finally to develop the OPEC nation's neglected gas reserves during a marathon nine-hour speech to parliament last week.

"We could even begin to approach Russia, No. 1 one in the global ranking, once we've certified the gas in the Orinoco oil belt and continue discovering the gas offshore," he said.

"This is very important and it has only been possible to achieve this through independence."

His government says it will eventually certify as much as 400 tcf in reserves, up from 195 tcf now. That would propel Venezuela to fourth in the world behind Russia, Iran and Qatar, according to U.S. Energy Information Administration data.

But Venezuela's gas projects have languished for years, stalled by pricing issues and industry fears of expropriations that made it hard for PDVSA to attract experienced partners.

The big difference now is that Chavez's government has hiked the tariff it is willing to pay its foreign partners for gas to $3.69 per million British thermal units.

That's sharply more than what PDVSA was prepared to shell out in the past - and, crucially, higher than the market price.

Low Demand, Weak Prices

The Perla deal would make little sense if South America's biggest oil exporter was also looking to sell its gas abroad.

Natural gas futures have crashed to their lowest level in a decade - $2.348 on Thursday - as a glut of gas from U.S. shale fields swells inventories.

Combined with the global economic woes, it means demand and prices are likely to stay weak throughout 2012.

Instead, Venezuela will use the Perla output to feed its increasingly hungry domestic market. And though details have not been made public, the government has won agreement to pay part of the tariff in its over-valued local bolivar currency, which cuts the overall cost of the agreements to PDVSA.

"Venezuela needs that gas, which is why they gave quite a good price," said Carlos Bellorin, senior oil and gas analyst at IHS Petroleum Economics and Policy Solutions.

"With the right price, this project can be beneficial for all parties involved. Apparently, this has been accomplished."

All eyes are now on negotiations with Russian giant Gazprom (GAZP.MM) over Robalo, a nearby offshore area, a 2010 agreement for Chevron (CVX.N) to develop part of the Plataforma Deltana offshore project thought to hold 7 tcf, and PDVSA's solo efforts to kickstart production from its own projects.

Discussions about Plataforma Deltana appear to be in limbo because its output was destined for export as liquefied natural gas. Last year, Venezuela froze its LNG projects due to low global prices, meaning the licenses would need to be revised.

PDVSA is still seeking partners for its other high profile offshore area - Mariscal Sucre, with estimated reserves of 14.7 tcf - and officially production is set to begin in November. But experts say that is likely to be delayed, not least by the sinking of a $200 million exploration rig there in May 2010.

Part of PDVSA's difficulties finding partners for Mariscal Sucre for has been its insistence that any potential investor assume part of what it says was a total loss of more than $600 million from that disaster.

Onshore, power shortages that caused widespread rationing and curbed economic growth during 2010 are a still burning political issue for Chavez during an election year.

The country relies heavily on hydroelectric dams and is scrambling to boost its gas- and diesel-fueled generation. As a result, it has had to import gasoline when it would much rather be selling its own stocks overseas.

None of these gas projects will help keep the lights on before this October's vote - but the garrulous president has often vowed to stay in power until 2031, so presumably he sees this as a longer term priority.

Perla is a Real Jewel

Perla is the one most likely to bear fruit first. PDVSA has said early production is estimated at 80 million cubic feet per day and could begin to be pumped as early as October, although most analysts expect the first output in 2013.

The agreement between PDVSA, Repsol and ENI runs until 2036 and will supply the Venezuelan domestic market

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with more than 8.7 tcf. There will be plenty of takers: Perla sits in just 200 ft of water, only about 30 miles out into the Caribbean from PDVSA's Paraguana Refinery Complex, which is one of the biggest in the world and uses lots of gas in its operations.

Perla is also near the El Tablazo petrochemical center, another potential consumer, and the Lake Maracaibo crude fields in the heart of Venezuela's traditional oil heartland. Many have been tapped for decades and their output is falling - but the decline could be slowed using gas re-injection techniques.

Eventually, gas could also be used to boost recovery from the area that forms the centerpiece of Venezuela's future energy plans: the vast Orinoco extra heavy crude belt, seen as one of the largest mostly-untapped oil reserves left in the world.

Visiting Caracas to sign the deal, Repsol's chairman Antonio Brufau called Perla a "flagship project" and ENI boss Paulo Scaroni also waxed lyrical: "Perla is a real jewel," he said.

Both their companies already have important stakes in the Orinoco, as does Gazprom, and both men will hope their support for Venezuela's fledgling gas sector gives them more clout if they need to revise their other agreements down the road.

The government is still reviewing proposals to modify its gas law to increase taxes and put any production projects solely in the hands of joint ventures with majority PDVSA participation - as is already the case with oil projects in Venezuela.

It is all part of a drive by Chavez to secure for the state a greater share of resources from energy projects. He says PDVSA had a "slave mentality" and was in hock to foreign companies, before he sacked thousands of its managers after a 2002 strike.

"The old PDVSA ... they told me many times: There's no gas here president, forget about gas, Venezuela doesn't have gas," he said during his prolonged speech to parliament.

"Of course, they already had the gas negotiated or pre-negotiated to give to the multinationals ... the companies were paying 1 percent royalties, 1 percent! Now they pay 33 percent, under the petroleum law of an independent republic." ❑

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