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# THE DEVELOPMENT OF PERUVIAN LAW FOR PETROLEUM SUBCONTRACTORS

*Stanley F. Rose\**

## I. INTRODUCTION

The Revolutionary Government of the Armed Forces of Peru under the leadership of General Juan Velasco Alvarado assumed the government of Peru on October 3, 1968.<sup>1</sup> One reason given for the assumption of power was that Peruvian interests had been severely damaged in the Act of Talara of August 13, 1968.<sup>2</sup> After nullifying the Act of Talara, the Government expropriated the International Petroleum Company (IPC) refinery in Talara.<sup>3</sup> As revealed in 1974 by the publication of the Revolutionary Government's plan of strategy, "Plan Inca," the Peruvian military had a clear idea of what it believed the situation of the Peruvian petroleum industry was on October 3, 1968,<sup>4</sup> what its objective was

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1. Rose, *Peru: An Introduction to Peruvian Law for Lawyers and Businessmen*, TAX MANAGEMENT INT'L J., Feb., 1975, at 6-7 [hereinafter cited as Rose]. The present president of Peru is General Francisco Morales Bermudez who succeeded General Velasco in a bloodless *coup d'état* on August 29, 1975. The Washington Post, Aug. 30, 1975, at 1.

2. The Act of Talara was an agreement between the Peruvian Government of President Fernando Belaunde Terry and the International Petroleum Company (IPC), in which the latter company returned to the State the petroleum deposits of La Brea and Parinas in exchange for some very favorable petroleum concessions, to include retention of the property of the IPC refinery in Talara and the establishment of a favorable sales price for crude oil sold to the Talara refinery by the State petroleum company, Empresa Petrolera Fiscal (EPF). PERU: 1968-1973 CRONOLOGIA POLITICA 6 (1974). This Agreement was heavily criticized in the Peruvian Congress and press and nullified on October 4, 1968, by the Velasco Government. Decree Law No. 17065 of Oct. 4, 1968.

3. Decree Law No. 17066 of Oct. 9, 1968. It is not the intent of this article, nor within its scope, to discuss the IPC problem, which has been the subject of many articles and books. See generally J. EINHORN, EXPROPRIATION POLITICS (1974); EXPROPRIATION IN THE AMERICAS: A COMPARATIVE LAW STUDY (A. Lowenfeld ed. 1971); A.J. PINELO, THE MULTINATIONAL CORPORATION AS A FORCE IN LATIN AMERICAN POLITICS: A CASE STUDY OF THE INTERNATIONAL PETROLEUM COMPANY IN PERU (1973); Goodwin, *Letters from Peru*, THE NEW YORKER, May 17, 1969.

4. The situation of the petroleum industry is described below. Almost all petroleum activities were in foreign hands, the State petroleum company, Empresa Petrolera Fiscal (EPF), was without economic importance, bureau-

regarding that industry,<sup>5</sup> and what actions it needed to take in furtherance of that objective.<sup>6</sup>

The Revolutionary Government's plans to end the petroleum concession system were subsequently placed into law by Decree Law No. 17440, which states that petroleum deposits and deposits of analogous hydrocarbons are the property of the State and cannot be alienated or relinquished. The petroleum industry and marketing of petroleum and analogous hydrocarbons and derivatives, as well as basic petrochemicals, are of national interest, public utility, and indispensable for the integral security (*seguridad integral*) of the State.<sup>7</sup>

As of February 20, 1969, the effective date of Decree Law No. 17440, the petroleum concession system was abolished, although all acquired rights were to be respected. Under the Decree Law, the petroleum industry and all marketing of petroleum and analogous hydrocarbons is to be carried out primarily by the State. Private companies can bid for the rights to carry out prospecting, exploration, exploitation, and manufacturing under a contract system, in accordance with the State's interests, as expressed through the Ministry of Energy and Mines or the state oil company, *Empresa Petrolera Fiscal* (EPF).<sup>8</sup>

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cratic, and inefficient. IPC had a virtual monopoly over Peruvian petroleum activities and no legal title, and the same company had established a long record of pressure which had culminated in a contract, the Act of Talara, which was a complete sell-out by forgiveness of debts owed to the Peruvian government as well as the grant of concessions against the national interest. The Peruvian Times, Aug. 2, 1974, at 10.

5. *Id.* The military's objective was that the State be exclusively in charge of all stages of petroleum activity.

6. *Id.* The military planned the following actions: (1) annul the contract signed with IPC on August 12, 1968, as well as the Talara memorandum and all related actions; (2) expropriate the IPC properties and through it collect debts owed to the State; (3) create a strong State oil company; (4) eliminate the petroleum concession system; and, (5) in two stages, set up a system of contracts under which companies would explore for and exploit petroleum for the State until the State developed the capacity to carry out all petroleum activities, and, once such capacity is achieved, to have the State exclusively participate in petroleum activities.

7. Decree Law No. 17440 of Feb. 18, 1969, arts. 2, 4.

8. *Id.* arts. 5-6. The previous concessions continued to be governed by the Peruvian Petroleum Law of 1952, Law No. 11780, and its regulations. Law No. 11780 of March 12, 1952, and the Regulation of the Law of Petroleum of June 10, 1952. A law (or Decree Law) is in force from the day following its promulgation and publication, unless the law (or Decree Law) itself states that its effective date will be different. POLITICAL CONSTITUTION OF PERU, art. 132 (1933). Thus, Decree

Subsequently, EPF was reorganized by Decree Law No. 17753 of July 24, 1969, and renamed *Petroleos del Peru* (Petroperu). This entity is presently governed by Organic (Basic) Law, Decree Law No. 20036 of May 29, 1973. Petroperu is in charge of all state management direction in industrial and commercial activities related to petroleum and analogous hydrocarbons, including their derivatives and all activity in basic petrochemicals.<sup>9</sup> In the areas of exploration, exploitation, refining, marketing, and transportation of petroleum, natural gas and their derivatives, Petroperu is to conduct directly or indirectly through contracts all studies and work activities in accordance with pertinent legislation.<sup>10</sup>

During 1969 and 1970, a number of foreign petroleum companies began negotiating with Petroperu to enter into service contracts for the exploration of oil and exploitation of natural resources in the Peruvian jungle areas and along Peru's northern coast. The first of the "Peruvian Model Contracts" was signed on June 22, 1971, by the Peruvian branch of Occidental Petroleum Corporation of Peru.<sup>11</sup> Prior to the signing of that contract, several Decree Laws were necessary to change existing legislation to facilitate the operation of the petroleum companies in Peru.

The first of these laws, Decree Law No. 18883, states that prospecting, exploration, and exploitation of petroleum and analogous hydrocarbons in areas located within 50 kilometers of the Peruvian borders, and the transport of such products, are of "national necessity."<sup>12</sup> Petroperu is authorized to enter into contracts for prospecting, exploration, and exploitation in such areas, as well as contracts regarding transportation with foreign or national, natural or juridical persons.<sup>13</sup> These contracts may provide for payment in currency or specie and should be authorized by the Executive Branch, if there is a prior favorable opinion of the Peruvian Joint Chiefs of Staff in respect of national security.<sup>14</sup>

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Law No. 17440 of Feb. 18, 1969, is in force as of February 20, 1969, because it was published in the official newspaper, *El Peruano*, on February 19, 1969.

9. Decree Law No. 20036 of May 29, 1973, art. 5.

10. *Id.* art. 6(a).

11. See Supreme Decree No. 003-71-EM/DS of June 22, 1971, which approves the Petroperu-Occidental contract and authorizes Petroperu to sign it. This Supreme Decree was published in *El Peruano* on June 23, 1971, along with the text of the operations contract under which the contractor, Occidental, agrees to carry out petroleum operations in a contract area for Petroperu.

12. Decree Law No. 18883 of June 15, 1971, art. 1.

13. *Id.* art. 2.

14. *Id.* art. 3.

Another law, Decree Law No. 18890, permits the Central Reserve Bank to intervene in the contracts which the State and/or Petroperu signs with foreign oil companies for new investments, for the purpose of guaranteeing the availability of foreign currency during the term of the contracts. The guaranteed foreign currency is for allowable remittances abroad of net profits free to the enterprise, depreciation and justified services, amortization of loans entered into abroad and used by the company within Peru, and interest payable thereon.<sup>15</sup> Annual remittances are not to exceed a sum equivalent to the net profits (free to the enterprise), plus depreciation.<sup>16</sup>

Subsequently, on June 22, 1971, Occidental Petroleum Corporation of Peru, Peruvian Branch, signed a contract of Petroleum Operations (an operations contract) with Petroperu.<sup>17</sup> The con-

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15. Decree Law No. 18890 of June 17, 1971, art. 1. In practice, the loan monies are either remitted to Peru for working capital or used abroad to purchase equipment or to pay salaries, subcontractor services, and other foreign currency obligations.

16. *Id.* These financial guarantees are included in Clause IX of the operations contract. See note 17 *infra*. See also Supreme Decree No. 316-75-EF of Dec. 30, 1975, for a clarification of Decree Law No. 18890 of June 17, 1971; Supreme Decree No. 316-75-EF, as published in *El Peruano*, Jan. 6, 1976. Remittances in any one year cannot be greater than gross revenues (GR) minus expenditures in local currency (E). This sum is arrived at in the following manner:

$$\text{Net Profits Free to the Enterprise (NP)} = \text{GR} - \text{E} - \text{D} \\ \text{(depreciation)}$$

$$\text{Remittances} = \text{NP} (\text{GR} - \text{E} - \text{D}) + \text{D}$$

$$\text{Remittances} = \text{GR} - \text{E} - \text{D} + \text{D} = \text{GR} - \text{E}$$

Thus, the remittances are equivalent to available cash, not book profit plus depreciation.

17. *Id.* This contract was approved by Supreme Decree No. 003-71-EM/DS of June 22, 1971, and signed by both parties and the Director Superior of the Ministry of Economy and Finance representing the State. The Central Reserve Bank of Peru intervened in the contract, guaranteeing foreign currency under Decree Law No. 18890 of June 17, 1971. The signature of the first "Peru Model Petroleum Contract" was followed by 17 others involving the following companies, either solely or jointly, in operations with Petroperu: Tenneco Oil Company of Peru, Union Oil Company of Peru, British Petroleum Peru Limited, Amoco Peru Petroleum Company, Pecten Petroleum Company of Peru (Shell Pecten), Phillips Petroleum Company of Peru, Arco Peru Corporation (Atlantic Richfield), Getty Oil (Peru) Inc., Pan Ocean of Peru (Pan Ocean Oil Company), Transworld Peru Petroleum Corporation, Peruvian Sun Oil Company, Continental Oil Company of Peru, Champlin Peru Inc., Peru Cities Service Inc., Andes Petroleum Company Ltd., Signal (Peru) Petroleum Company, Deminix, Superior Oil Company of Peru, Sumisho Peru Sekiyu Kaihatu Kabushiki Kaisha, Amerada Hess Corporation of Peru, Oceanic Exploration Company of Peru, El Paso Oil Company of Peru, Charter Oil Company of Peru, Hispanoil, Total-Peru, Saga Petroleum A/S,

tract states that Occidental will provide all technical and financial resources required to carry out petroleum operations in Peru and will be solely responsible for all costs and expenses incurred in that respect. Petroperu and the Peruvian State will not assume any risk in respect of work to be carried out by Occidental, except as provided in the part of the contract dealing with the construction of any necessary pipeline to the coast or to any other point in Peru.<sup>18</sup> The term of the contract is thirty-five years from the date of its signing,<sup>19</sup> and during such term all petroleum produced in the operations is to be divided in kind between Petroperu and Occidental.<sup>20</sup> Occidental is to receive 50 per cent of the total produced, plus a portion of the remaining 50 per cent equivalent to its taxes under Peruvian law.<sup>21</sup> The balance of the petroleum will belong to Petroperu.<sup>22</sup>

Occidental agreed to enter into a guaranteed exploration program during the first four years of the contract, to include a photo-geologic survey of the contract area, seismic studies of the contract area, as well as other geologic and geophysical studies, which Occidental may consider necessary in order to select initial drilling sites, and the drilling of at least three oil wells even if the prospecting results and conditions prove unfavorable.<sup>23</sup> Additional drilling commitments are contemplated after the fifty-fourth month of the

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Shenandoah Oil Corporation, and Belco Petroleum Company. Andes Petroleum Company, Ltd., Deminix, Hispanoil, Total-Peru, and Saga Petroleum A/S, respectively, are connected, directly or indirectly, with the governments of Japan, West Germany, Spain, France, and Norway. Belco Petroleum Company, the last major remaining concession holder in Peru, agreed to change to a "Peru Model Petroleum Contract" in August 1973. All the contracts signed were for work in the jungle area of Peru, except for a joint venture between Tenneco and Union Oil and the Belco contract, both of which pertain to oil exploration offshore of the Peruvian northern coast.

18. *Petroleos del Peru—Occidental Petroleum Corporation of Peru, Peruvian Branch, Contract of Operations of June 22, 1971, Clause II, point 2.3; Clause X [hereinafter cited as Contract].*

19. *Id.* Clause III, point 3.1.

20. *Id.* Clause II, point 2.4.

21. *Id.* Clause VI, point 6.2(a), (b). The 50% for Occidental is received in kind at the field gathering station, and the portion equivalent to taxes is retained at that point by Petroperu, which will pay in cash the income taxes and profits taxes for the account of Occidental, upon Occidental's preparation of the proper income tax forms. Occidental receives the corresponding tax receipt in its name. *Id.* Clause VI, points 6.2(a), (b) and Clause VII, points 7.2, 7.3.

22. *Id.* Clause VI, point 6.2.

23. *Id.* Clause IV, points 4.2(a), (b), (c). This exploration program is backed by a bank guarantee. *Id.* Clause III, point 3.2.

contract,<sup>24</sup> and Occidental has seven years from the date of signing to declare that it has made a commercial discovery of petroleum that it plans to exploit.<sup>25</sup>

Moreover, Occidental agreed to subject itself to the jurisdiction of the Peruvian courts and laws<sup>26</sup> and to comply with all Peruvian legal, tax, and accounting requirements.<sup>27</sup> In addition to the income tax and profits taxes payable, which are retained in kind at the field gathering station,<sup>28</sup> Occidental agreed to pay a number of taxes for its own account, including the share capital tax, the business license tax, taxes on real estate and income therefrom, taxes on non-utilized property, stamp taxes, export taxes, and various labor law taxes and contributions.<sup>29</sup>

The operations contract between Petroperu and Occidental includes certain customs rights. Occidental is authorized to import into Peru any items which may be required to carry out economically and efficiently the petroleum operations of Occidental or its subcontractors.<sup>30</sup> All import duties are for the account of Petroperu.<sup>31</sup>

## II. THE PETROLEUM SUBCONTRACTORS

The model contracts clearly state that Petroperu will not be

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24. *Id.* Clause IV, point 4.4. This includes one additional well every five months from the 54th through the 79th month of the contract.

25. *Id.* Clause III, point 3.1.

26. *Id.* Clause XIV, point 14.1. This is the traditional use of the "Calvo Clause" which is included in article 17 of the 1933 Political Constitution of Peru. Such agreement includes the renunciation of the use of any diplomatic claims.

27. *Id.* Clause VII, point 7.1.

28. *See* note 21 *supra*. The field gathering station is the point in the contract area where the petroleum is collected, quantified, and divided among the parties according to ownership. Up to that point, Petroperu is the sole owner of the petroleum. The applicable income tax rates under the operations contract are not to be lower than those rates in force at the date of signature of the operations contract, *i.e.* 25% during the first 10 years after the date of the first sale made by Occidental from its share of petroleum from the contract area, 35% during the following 10 years, and 50% during the balance of the life of the Contract. Contract, Clause VII, points 7.1(i), (ii), (iii). In addition, a 30% branch profits tax is payable. Supreme Decree No. 287-68-HC of Aug. 9, 1968, art. 61(b) (given force of law by Decree Law No. 17004 of Feb. 18, 1969) [hereinafter cited as Supreme Decree No. 287-68-HC]. This creates an effective tax rate of 47.5% during the first 10 years, 54.5% during the subsequent 10 years, and during the remaining period of time, a 65% effective rate is applicable.

29. *See* Contract, Clause VII, point 7.4.

30. *Id.* Clause VIII, point 8.1.

31. *Id.*

responsible for paying any income tax or other tax assessed against petroleum subcontractors, or against natural or juridical persons not domiciled in Peru who provide services or financing.<sup>32</sup> Consequently, except in the case of importation of equipment under the contractor's umbrella, the subcontractors are subject to legislation which is not necessarily designed to cope with the problems of regulating petroleum subcontractors operating in jungle areas. This has caused, and continues to cause, the petroleum subcontractors to move slowly over uncertain legal terrain where legislation in many instances is lacking. Moreover, due to the difficulty of operations in the jungle, certain incentives have been implemented to enable the companies to operate profitably in Peru.

### A. Major Jungle Legislation

Prior to 1971 there existed a broadly worded law dealing with the Peruvian jungle area, in which tax exonerations were granted. Law No. 15600 (the "Jungle Law") provides exemptions for a period of fifteen years from September 4, 1965, for corporate and personal income taxes, certain export and import taxes, registration and transfer taxes, inheritance taxes, and stamp taxes.<sup>33</sup>

The regulations to the Jungle Law established criteria for the tax exonerations for natural and juridical persons. Natural persons must be domiciled in the jungle area, carry out at least 75 per cent of their activities there, and be able to provide the receipt for their last payment of the business license tax.<sup>34</sup> If these requirements are inapplicable, natural persons must be able to produce a certificate granted by the police in whose jurisdiction they are domiciled

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32. For an example of such phraseology, see Contract, Clause VII, point 7.7. Petroleum subcontractors provide a variety of services including drilling oil wells, constructing roads and labor camps, providing supplies, labor, air support, and geophysical and seismic work for oil field operations.

33. Law No. 15600 of Sept. 4, 1965, arts. 1, 5 [hereinafter cited as Law No. 15600].

34. *Id.* art. 2. The jungle area is basically all territory east of the Andes at an altitude of less than 2,000 meters above sea level and includes the entirety of the Departments of Loreto, Madre de Dios, San Martin, and Amazonas. Activities included within the Jungle Law that could be related to petroleum include construction activities as classified by the International Industrial Classification of all Economic Activities of the United Nations. UNITED NATIONS *Indexes to the International Standard Industrial Classification of all Economic Activities*, Statistical Papers Series M, No. 4, Rev. 2, Add. 1, at 35-6 (indexed ed. 1971). Also included are marketing of articles related to activities carried out in the jungle area and transportation activities in the jungle area. Law No. 15600, art. 3.



which proves that they carry out at least 75 per cent of their activities in that jurisdiction.<sup>35</sup> For juridical persons, additional phraseology was added to include a clear stipulation that they should carry out at least 75 per cent of their activities and administration in the jungle area. Local corporations (*Sociedades Anonimas*), benefiting from the Jungle Law regime, must issue nominative shares.<sup>36</sup>

A subsequent law, No. 16763, extended the Jungle Law exonerations to natural and juridical persons who, for their own account or for the account of third parties, carry out studies or prospect for natural resources in the jungle area.<sup>37</sup> Decree Law No. 18841 adds that there would be an exoneration from income tax on the profits of non-juridical persons, and on the dividends of entities established or to be established in the jungle area by natural or juridical persons not domiciled in the jungle area, except for profits remitted abroad.<sup>38</sup> However, both of these laws created certain doubts that were not resolved until the Peruvian Tax Department issued Report No. EF/74-06-1337-73, which stated that the drilling of oil wells is an activity contemplated under Law No. 16763, and that the tax exonerations which apply to branches of foreign companies under the Jungle Law do not apply to profits available to their parent organizations.<sup>39</sup> A final piece of tax legislation was issued on September 7, 1971, to assist Petroperu, Decree Law No. 18951 established that natural and/or juridical persons, not domiciled in Peru, are exonerated from income taxes and stamp taxes imposed on remittances abroad if they contract with the State or with Pe-

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35. Supreme Decree No. 401-H of Oct. 4, 1965, art. 3 [hereinafter cited as Supreme Decree No. 401-H].

36. *Id.* For purposes of this article, a local corporation is a corporation established in Peru, as opposed to a foreign corporation, *i.e.* a corporation formed outside Peru.

37. Law No. 16763 of Dec. 7, 1967.

38. Decree Law No. 18841, art. 1, *as published in El Peruano*, April 28, 1971.

39. T. Nichtawitz, C. Talledo & B. Merino, *Regimenes Especiales de Tribu-tacion*, V EDITORIAL ECONOMIA Y FINANZAS S.C.R.L. 252 (Current Loose Leaf Service on Special Peruvian Tax Regimes). As will be explained later, local corporations pay income taxes (exempt under Law No. 15600) and taxes on dividends when they are declared (not exempt if remitted abroad to their parent company in accordance with Decree Law No. 18841). A branch pays income tax (exempt under Law No. 15600) and branch profits tax, on an annual basis (not exempt as per report No. EF/74-06-1337-73). The reason for this is that a branch pays branch profits tax on its profits as it earns them, and thus, in theory, all after-tax profits of a branch on a yearly basis are available for its parent organization located outside Peru. By interpretation, art. 1 of Decree Law No. 18841 is applied.

troperu for services or if they rent equipment for exploration activities in the jungle area, where the State has not contracted to third parties.<sup>40</sup>

Although seemingly clear on its face, Law No. 15600 and its regulations left unresolved whether branches were eligible for Jungle Law exoneration, and whether foreigners could qualify for the exonerations prior to residing in Peru for two years. The question concerning branches arose from the reference in Law No. 15600 to juridical persons established with nominative shares and the absence of any mention of branches in that article.<sup>41</sup> It appeared that the regulations to the Jungle Law were intended to clear up this ambiguity as they referred to juridical persons, and stated that local corporations should be established with nominative shares.<sup>42</sup> However, branches are not juridical persons per se and may not have a juridical personality distinct from that of their home office,<sup>43</sup> except where a specific law confers juridical personality for a particular purpose. For example, Peruvian branches of sole proprietorships established abroad are considered to be juridical persons.<sup>44</sup> Entities of all types established abroad, with branches in Peru, are considered to be juridical persons,<sup>45</sup> but their branch does not have separate juridical personality.<sup>46</sup> This point has not been resolved by the Peruvian Tax Authorities although, as a practical matter, branches are being established in the jungle area and are enjoying the Law No. 15600 exoneration.<sup>47</sup>

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40. Decree Law No. 18951, as published in *El Peruano*, Sept. 8, 1971.

41. Law No. 15600, art. 4(b).

42. Supreme Decree No. 401-H, art. 3(b). "Tratandose de las Sociedades Anonimas, sus acciones deberan ser nomenclativas."

43. U. MANFREDI, *COMENTARIOS A LA LEY DE SOCIEDADES MERCANTILES* 507 (1967).

44. Supreme Decree No. 287-68-HC, art. 14(e).

45. *Id.* art. 14(d).

46. *Id.* arts. 6, 7(e), 14(d). Questions of taxation in this case depend on the domicile of the Peruvian branch and its home office. Only the former is considered to be domiciled and subject to taxation on world-wide income. The home office is only subject to taxation of Peruvian source income, thus, the rationale for the application of the branch profits tax discussed in note 39 *supra*.

47. See Rose, *supra* note 1 at 18, n.35. This is an example of not asking a question which might create a problem if a negative answer were given, *i.e.* that branches did not have a Law No. 15600 exoneration. As a matter of practice, this could be argued from a number of viewpoints: the branches were intended to be included and that the regulations were written to include them in spite of the references to "juridical persons" and the absence of references to branches; that the Tax Department Report No. EF/74-06-1337-73 recognizes branches or, con-

The jungle area income tax exonerations for foreign natural persons have recently been clarified. This particular problem arose over the interpretation of domiciliary status. The Peruvian tax law defines "domiciliaries" to include natural persons of Peruvian nationality who are domiciled in Peru in accordance with the norms of law (*i.e.* the civil law rules) and foreign natural persons who have resided or remained in Peru for two or more years in a continuous manner. Absences of up to ninety days in a tax year do not interrupt this continuity.<sup>48</sup> A natural person retains his status as a domiciliary as long as he is not absent from the country for a two-year period or longer in a continuous manner. Natural persons are judged to be domiciled depending on their condition at the commencement of each tax year. Any changes in their status occurring during a tax year are applicable from the beginning of the following year.<sup>49</sup>

Non-domiciled taxpayers may choose to be treated as domiciled persons.<sup>50</sup> To receive this treatment they must have resided in Peru for six months and be inscribed in the National Taxpayers' Registry.<sup>51</sup> As mentioned previously, the Jungle Law states that natural persons can qualify for benefits granted under the Law if they have

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versely, that since branches of foreign corporations were not mentioned in the regulations to clarify this point, nor in the Jungle Law itself, that they are not included due to the specificity of the phrases "natural persons" and "juridical persons." An argument contrary to the interpretation of the phrase regarding local corporation, in article 3 of Supreme Decree No. 401-H, in the sense that such phrase tacitly permits branches, is that the regulation is a Supreme Decree and of a lower order in the legal hierarchy than a Decree Law or a law. Thus it would be modifying the law itself. This is contrary to the Constitution. See POLITICAL CONSTITUTION OF PERU art. 131; Furnish, *The Hierarchy of Peruvian Laws: Context for Law and Development*, 18 AM. J. COMP. L. 456, (1971).

48. Supreme Decree No. 287-68-HC, art. 7. Such absences cannot exceed a total of 90 days in any tax year. Supreme Decree No. 015-69-HC, art. 5, as published in *El Peruano*, Jan. 25, 1969.

49. Supreme Decree No. 287-68-HC, art. 8.

50. *Id.* art. 9.

51. Supreme Decree No. 015-69-HC, art. 7, as published in *El Peruano*, Jan. 25, 1969. It originally appeared that such time period should be uninterrupted and that to exercise such option, an express manifestation of intent by the taxpayer would be necessary, either in a sworn declaration (*Declaracion juranda*) or in a special communication. T. Nichtawitz and H. Valdez Arrospide, *Manual de Impuesto a la renta*, II EDITORIAL ECONOMIA Y FINANZAS S.C.R.L., 23 (Loose Leaf Service on Special Peruvian Tax Regimes). However, Tax Court Resolution No. 9891 established that temporary absences of not more than 90 days in each tax year would not interrupt the continuity of the residence. Tax Court Resolution No. 9891 of Oct. 11, 1974.

established their domicile in the jungle area<sup>52</sup> and carry out 75 per cent of their activities in that area.<sup>53</sup>

Subsequent regulations reaffirmed the requirements of a jungle area domicile and 75 per cent activity within the area, and added as an additional requisite the exhibition of the receipt for payment of an operating or professional license tax. In the event that an individual is not required to obtain such a license, it is sufficient to present a declaration (*constancia*) from the police authorities of the place where the person is domiciled that proves he carries out at least 75 per cent of his activities there.<sup>54</sup>

Until recently, a Tax Court case and a Tax Department report clouded this issue. In a case in which an assessment was levied against a taxpayer of two months residence, the Tax Court ruled that the aforementioned two-year rule would be applicable when a foreigner attempted to establish his domicile in the jungle area.<sup>55</sup> The case was not well reasoned and left open the question whether a different result would have been reached had there been at least six months residence and a police report had been obtained. A subsequent information report by the tax authorities stipulated that in order for technicians to benefit from the tax exoneration of Law No. 15600, they must be domiciled in the jungle area and prove that they carry out at least 75 per cent of their activities therein.<sup>56</sup> However, in a recent Tax Court decision, the court varied its criteria and stated that instead of applying the two-year rule, the condition of domicile should be determined in conformity with article 19 of the Peruvian Tax Code.<sup>57</sup> The criteria expressed therein establish that the domicile of natural persons is presumed to be the place of their habitual residence when there exists an uninterrupted presence in such place for greater than six months in the year.<sup>58</sup> The place of residence is considered to be that place

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52. Law No. 15600, art. 4.

53. *Id.* There are no written guidelines on how to measure this percentage. However, art. 11 of Supreme Decree No. 401-H establishes a test based on the source of revenue earned.

54. Supreme Decree No. 401-H, art. 3.

55. Resolution of the Tax Court No. 5784, Nov. 6, 1970.

56. Report No. 048-72 *Direccion General de Contribuciones*, Jan. 21, 1972. This report could not state guidelines contrary to the Tax Court decision mentioned in note 55 *supra* and its accompanying text.

57. Resolution of the Tax Court No. 10600, July 14, 1975. This case arose because the foreigner had temporarily left the country prior to lapse of the six months and had to liquidate his taxes in order to obtain an exit clearance.

58. Supreme Decree No. 263-H, *Codigo Tributario*, Aug. 12, 1966, art. 19(a)

where the person carries on his civil and commercial activities.<sup>59</sup> Even though a foreigner was involved in that case, it is probable that the same rule would apply to Peruvians working in the jungle area.<sup>60</sup>

### B. *Subcontractor Income Taxation*

Under Peruvian law, juridical persons are subject to corporate income tax rates on a progressive scale from 20 per cent to 55 per cent.<sup>61</sup> This tax scale applies to local corporations and branches of companies domiciled abroad. Any dividend payments to a foreign shareholder by the local corporation are taxed at 40 per cent,<sup>62</sup> which may be reduced to 30 per cent under certain circumstances.<sup>63</sup> Branches are taxed at the rate of 30 per cent on the after-tax profits available for their home office.<sup>64</sup> Law Nos. 15600 and 16763 and Decree Law No. 18841 exonerate qualifying petroleum subcontractors in the jungle area from the abovementioned progressive scale, but not from the dividend or branch profits tax.<sup>65</sup> Two other tax rates with potential effect on certain petroleum subcontractors and service companies are the 40 per cent tax rate on "other income" of non-domiciled juridical persons<sup>66</sup> and the effective tax

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(given force of law by Law No. 16043 of Feb. 4, 1966) [hereinafter cited as Peruvian Tax Code].

59. *Id.* art. 19(b).

60. Also, are the first six months tax free? A reading of article 19 of the Peruvian Tax Code would permit such a conclusion.

61. Decree Law No. 18078, as published in *El Peruano*, Dec. 31, 1969.

62. Supreme Decree No. 287-68-HC, art. 61(a).

63. *Id.* This reduction can be authorized if the recipient of the dividend will be subject to tax in his country of residence on Peruvian source income at a rate not less than 30% (ignoring the effect of any foreign tax credit) or if the recipient of the dividend is a company in which Peruvians and foreigners resident in Peru do not either solely or jointly, directly or indirectly, hold 40% or more of the capital and, also, the payor company is operating in a sector of the economy declared to be of national interest.

64. *Id.* art. 61(b). Profits available to the home office are considered to be yearly taxable income minus income tax paid, applying the progressive scale of 20% to 55%.

65. See notes 33, 38-39 *supra* and accompanying text. It should be pointed out that, as mentioned above, branches pay taxes on their profits when earned; however, a local corporation will only make a tax retention for payments of tax on dividends when the dividends are declared. Supreme Decree No. 287-68-HC, art. 82.

66. *Id.* art. 61(f). Equipment rentals from abroad are included in this category if they are not linked with services, as will be explained subsequently in this article.

rate of 24 per cent on technical services and assistance performed for a local entity by a non-domiciled juridical person.<sup>67</sup>

During 1971 and early 1972, it became clear that a special tax regime should be established in order to equitably regulate the tax burden on petroleum subcontractors according to the entity's domicile. Consequently, Decree Law No. 19438 was issued on June 13, 1972, to establish a "simple and just" system of taxation for petroleum subcontractors carrying out operations in Peru based on the entity's domicile.<sup>68</sup>

This Decree Law established a tax base for both domiciled and non-domiciled petroleum subcontractors carrying out operations of exploration, drilling, development, and transportation in the petroleum industry. It includes a tax base of 25 per cent of gross revenues for non-domiciled service contractors and subcontractors carrying out specific works under contracts signed in Peru or abroad.<sup>69</sup> For foreign service contractors and subcontractors domiciled in Peru, there is established a minimum tax base of 15 per cent of gross revenues originating from work related to exploration, drilling, transportation, and development in the petroleum industry, under contracts signed in Peru or abroad.<sup>70</sup>

The effect of this Decree Law is very broad. Unofficial pronouncements of the Peruvian Tax Authorities have stated that equipment rentals cannot be included under this law unless they are connected with services. Additionally, the entire agreement for petroleum services must appear on its face to be a service agreement and not a pure rental. If such is the case, the aforementioned 40 per cent tax rate would be applied to a tax base of 25 per cent, rather than 100 per cent of gross revenues, thus reducing the effective tax rate for non-domiciled entities from 40 per cent to 10 per cent. Moreover, the effective tax rate of 24 per cent for technical

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67. This is the application of the 40% tax rate described in the text and note 66 *supra* to a tax base of 60% of the gross amount paid to a juridical person abroad, when such entity is performing technical assistance or technical services for a Peruvian entity. Decree Law No. 18150 of Feb. 17, 1970, art. 7. Generally these services are performed abroad although a small percentage of same may be performed in Peru. Decree Law No. 18150 establishes what is termed to be a presumed tax base, to which a tax rate may be applied.

68. Decree Law No. 19438, as published in *El Peruano*, June 14, 1972, (*Considerando*—opening considerations for the Decree Law) [hereinafter cited as Decree Law No. 19438].

69. This article adds a subpart (e) to article 49 of Supreme Decree No. 287-68-HC.

70. *Id.*

service agreements would not be applicable.<sup>71</sup>

The effect on domiciled subcontractors depends on the interpretation of the phrase "minimum taxable income" (*renta imponible minima*).<sup>72</sup> The "minimum tax base" system already existed in Peruvian law and still exists for entities providing telegram, telephone and other communications services,<sup>73</sup> air transportation service,<sup>74</sup> sea transportation,<sup>75</sup> news agencies,<sup>76</sup> film distribution,<sup>77</sup> insurance coverage (non-domiciled entities),<sup>78</sup> and technical services.<sup>79</sup> These entities, when carrying out the aforementioned activities have: (1) the appropriate corporate income tax rate applied to a percentage of gross revenue (a "minimum tax base"); (2) any dividend tax applied to the dividends actually declared for distribution; and (3) branch profits tax on the branch profits available to the home office.

The 15 per cent of gross revenues establishes the tax base for petroleum subcontractors. The effect is that even in a year in which expenses exceed gross revenues or the difference between gross revenues and expenses is less than 15 per cent of gross revenues, a tax is applied on the 15 per cent base. However, since this is a minimum base, if the difference between gross revenues and expenses is a positive amount greater than the 15 per cent of gross revenues, a tax is applied to the larger base.<sup>80</sup> As noted in the calculations provided in the footnotes to this section, the use of a local corporation has certain Peruvian tax advantages; however, these advantages must be compared by corporate planners to the advantage of establishing a branch of a Western Hemisphere

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71. See note 67 *supra* and accompanying text. Thus, with careful drafting and an understanding of the new tax regime, a subcontractor's costs as far as local tax could be reduced from 40% of a gross amount of U.S. \$100.00 or 24% of a gross amount of U.S. \$100.00, to a flat 10% on the gross amount.

72. Decree Law. No. 19438.

73. Supreme Decree No. 287-68-HC, art. 49(a)(1).

74. *Id.* art. 49(a)(2).

75. *Id.* art. 49(a)(3).

76. *Id.* art. 49(b).

77. *Id.* art. 49(c).

78. *Id.* art. 49.

79. *Id.* art. 49(d). See also note 67 *supra* and accompanying text.

80. Since the Decree Law No. 19438 is applied on a country-wide basis, there are certain subcontractors doing work offshore of northern Peru who do not benefit from the Jungle Law tax exoneration and, therefore, their tax base is at least 15% of gross revenues, on which both corporate taxes and branch profits tax or dividend taxes will be applied. The varying application of these regimes is demonstrated below.

Trade Corporation (WHTC) for its consequent benefits under United States tax law.<sup>81</sup>

C. *Subcontractor Profit Remittances*

Foreign currency may not be remitted from Peru without the prior approval of the governmental authorities. Presently, there are two exchange systems, the draft (*giro*) regime controlled by the

*Non-Jungle Entity*

	<i>Branch</i>			<i>Local Corporation</i>		
	1.	2.	3.	1.	2.	3.
Gross Revenues	100	100	100	100	100	100
Expenses	90	85	80	90	85	90
Minimum Tax Base	15	15	20	15	15	20
Corporate Tax (35%)	5.25	5.25	7	5.25	5.25	7
After Tax Profit	9.75	9.75	13	4.75	9.75	13
Branch Profit Tax (30%)	2.925(i)	2.925(i)	3.9(i)			
Dividend Tax (30%)				1.425(ii) (iii)	2.925(ii)	3.9(ii)
Available to Home Office Parent	1.825(iv)	6.825	9.1	3.325	6.825	9.1

(subject to profit remittance limitation to be discussed in section II.C.

- (i) applied when profits earned
  - (ii) applied only when dividends declared
  - (iii) dividends can only be declared out of actual profit and tax assessed on that amount
  - (iv) gross revenues minus expenses minus corporate tax minus branch profit tax.
- In theory, 6.825 is available; however, actual cash profit is only 1.825.

*Jungle Entity*

	<i>Branch</i>			<i>Local Corporation</i>		
	1.	2.	3.	1.	2.	3.
Gross Revenues	100	100	100	100	100	100
Expenses	90	85	80	90	85	80
Minimum Tax Base	15	15	20	15	15	20
Corporate Tax (exempt)	-	-	-	-	-	-
After Tax Profit	15	15	20	10(ii)	15(ii)	20(ii)
Branch Profit Tax (30%)	4.5(i)	4.5(i)	6(i)			
Dividend Tax (30%)				3(iii)	4.5(iii)	6(iii)
Available to Home office Parent	5.5(iv)	10.5	14	7	10.5	14

(subject to profit remittance limitations to be discussed in section II.C.

- (i) applied when profits earned
  - (ii) dividends can only be declared out of actual profits and tax assessed on that amount
  - (iii) applied only when dividends declared
  - (iv) gross revenues minus expenses minus branch profits.
- In theory, 10.5 is available, however, actual cash profit is only 5.5

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81. The author only knows of one local corporation established in the jungle area as a subsidiary of a domestic corporation (a United States based corporation), and, in that case, it is unclear after conversations with its executives that the actual advantages and disadvantages of subsidiary versus a branch of a WHTC were discussed and considered in detail.



Bank of the Nation (*Banco do la Nacion*),<sup>82</sup> and the certificate regime (*certificado de divisas*) of the Central Reserve Bank of Peru (*Banco Central de la Reserva del Peru*).<sup>83</sup> Under the certificate regime, the remittance of branch profits and depreciation is made to the branches' home offices abroad,<sup>84</sup> as well as dividend payments of companies established with foreign capital contributions invested in Peru through the Central Reserve Bank.<sup>85</sup> However, all dividend payments to foreign shareholders from investments made under the draft regime are paid through the Bank of the Nation.<sup>86</sup> Rental payments and technical service payments are made under the draft regime,<sup>87</sup> except in certain exceptional cases.<sup>88</sup>

In addition to the normal exchange control restrictions, petroleum subcontractors, whether formed in Peru as branches or local corporations, are restricted in their profit remittances to an annual amount equivalent to a net of tax sum not greater than 14 per cent of their direct foreign investment.<sup>89</sup> Direct foreign investment is

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82. Decree Law No. 18275, as published in *El Peruano*, May 26, 1970 [hereinafter cited as Decree Law No. 18275].

83. Decree Law No. 17710, as published in *El Peruano*, June 18, 1969 [hereinafter cited as Decree Law No. 17710].

84. *Id.* art. 8. Branches are limited in the amount of their yearly remittances to net profits of free disposition, plus depreciation. Supreme Decree No. 168-71-EF, as published in *El Peruano*, Dec. 4, 1971.

85. Decree Law No. 17710, art. 8.

86. Decree Law No. 18275, art. 14, as amplified by Supreme Decree No. 004-71-EF, art. 23, as published in *El Peruano*, Jan. 21, 1971 [hereinafter cited as Supreme Decree No. 004-71-EF]. Because the rate of exchange has been uniform for both exchange systems since September 25, 1965, this does not currently present a problem. However, it was previously possible to make an investment in a branch at the draft regime exchange rate, and remit profits and depreciation at the certificate regime rate, which was approximately 16% lower.

87. Supreme Decree No. 004-71-EF, arts. 29, 67.

88. Such exceptions include payments to foreign natural and juridical persons contracted abroad to carry out specific jobs for the public sector or for national or foreign companies with contracts with the public sector. Decree Law No. 20031, as published in *El Peruano*, May 24, 1973.

89. Decree Law No. 18900, as published in *El Peruano*, July 2, 1971. See art. 37 of Decision No. 24 of the Commission of the Cartagena Agreement [hereinafter all references will be made to Decision No. 24 and the appropriate article]. The exact wording of article 37 is that the foreign investors will have the right, with the prior authorization of the national competent body, to transfer abroad, in freely convertible currency, the proven net profits that come from the direct foreign investment, without exceeding annually 14% of the direct foreign investment. This article has been interpreted to be net of profits tax, and this application is being effected in Peru. Rose, *The Andean Pact and Its Foreign Investment Code*, TAX MANAGEMENT INT'L J., Jan., 1975, at 11 [hereinafter cited as Rose, *The Andean Pact*].

defined as capital contributions in freely convertible currency coming from abroad, the property of foreign natural persons or entities made as contributions to the entity, industrial plants, machinery, or equipment. This type of investment gives the entity the right to re-export the value of the contributed property and transfer profits from such contributions abroad.<sup>90</sup> Direct foreign investment is also considered to be investments made in national currency coming from resources that have a right to be remitted abroad.<sup>91</sup> Although this definition is very broad on its face, in Peru the capital base for remittance purposes is share capital for local corporations and assigned capital for branches.<sup>92</sup>

Due to the profit remittance limitations and exchange control restrictions, petroleum subcontractors in Peru have developed a *modus operandi* which enables them to operate in Peru and to provide services from abroad without running the risk of accumulating excess local currency that is not eligible for repatriation prior to sale of their local entity to national investors or liquidation.<sup>93</sup> Services by petroleum subcontractors for petroleum companies are generally rendered under two contracts. First, there is a contract between the home office of the subcontractor located abroad and either the home office of the petroleum company located abroad or the petroleum company's branch in Peru. This contract is for services to be rendered totally or partially abroad and payable in foreign currency. These services are taxed in Peru under Decree Law No. 19438 at a 10 per cent effective tax rate for non-domiciled entities,<sup>94</sup> and the tax is payable in Peru in foreign currency.<sup>95</sup> The contract is drafted tying services to equipment rental in order to avoid the flat 40 per cent tax rate applicable to the rental of equipment. Secondly, there is a contract in local currency in Peru for services to be rendered there by the subcontractor's local subsidiary or branch for the petroleum company's Peruvian branch. Since this is a contract between two local enti-

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90. Decision No. 24, art. 1.

91. *Id.*

92. Rose, *The Andean Pact* at 11.

93. Under Decision 24, the foreign investor may repatriate his investment upon sale of the entity to a national investor or liquidation of the entity. Decision No. 24, art. 7.

94. Decree Law No. 19438 (creation of 25% of gross revenues base upon which a 40% tax rate is applied).

95. Supreme Decree No. 015-69-HC, art. 56, as published in *El Peruano*, Jan. 25, 1969.

ties, the ordinary corporate tax rates are applied to taxable income, as determined under Decree Law No. 19438.<sup>96</sup>

#### D. *Local Shareholders*

As of July 1, 1971, under Decision No. 24 of the Cartagena Agreement Commission, all new foreign investment in Peru must be authorized by the government, and the foreign investors must agree to sell shares in their entity to national investors in order to have 51 per cent national ownership within fifteen years from the date production is initiated.<sup>97</sup> However, each member nation of the Cartagena Agreement, the Andean Pact,<sup>98</sup> has the right to apply its own legislation concerning the requirement for national shareholders in foreign entities in certain areas of business.<sup>99</sup> Consequently, petroleum subcontractors in Peru have been allowed to establish subsidiaries or branches subject to profit remittance limitations, but with no requirements as to national shareholders.

#### E. *Air Logistical Support*

An integral part of subcontractor operations in the Peruvian jungle has been logistical air support. Due to the Peruvian government's preoccupation with national security and its desire to guarantee the best interests of Peru,<sup>100</sup> air transport and support operations for petroleum exploration, mining, and similar activities involving the exploitation of natural resources, are reserved for exclusive performance by the State air service.<sup>101</sup> If the State does not have equipment available to carry out such work, it can be done by private national or foreign entities under contract with a State

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96. See note 80 *supra* and accompanying text.

97. Decision No. 24, art. 30.

98. This is a six country customs union whose members are Bolivia, Chile, Colombia, Ecuador, Peru, and Venezuela. The customs union was established by the Cartagena Agreement signed in Bogota, Colombia by all of the aforementioned countries on May 26, 1969 (except Venezuela), and entered into force on October 16, 1969. Venezuela agreed to enter the Andean Pact in February, 1973, and her entrance was formalized on January 1, 1974. Rose, *supra* note 1 at 26.

99. Decision No. 24, art. 44.

100. Decree Law No. 19482 of July 25, 1972 (*Considerando*—basic considerations).

101. *Id.* art. 1. The wording of this article was subsequently changed to read "exploration of natural resources" instead of "explotation," and to include the Peruvian Air Force as well as State air service companies. Decree Law No. 20106 of Aug. 7, 1973.

air service company.<sup>102</sup> In practice, this has caused the strengthening of the Peruvian Air Force and other State air support companies operating in the jungle area, as well as the development of some private national and foreign air support operations.<sup>103</sup>

#### F. *Equipment and Material Importation*

Under Clause VIII of any operations contracts, the petroleum company contracting with Petroperu is authorized to import into Peru whatever items may be required to carry out its petroleum operations economically and efficiently, including items for its subcontractors. The company's representative must certify to Petroperu, in accordance with prevailing legal dispositions, that items to be imported will be used in connection with the petroleum operations. He must also certify that at the time of placing the order, it is not possible to obtain the items in Peru on a competitive basis as to quality, price, and delivery date. Petroperu is to pay all taxes arising from these imports to the pertinent collecting entity for account of the company.<sup>104</sup> It is through this disposition that petroleum subcontractors in Peru have been able to import their equipment into Peru. While several subcontractors have been able to import certain materials under the Jungle Law import exonerations, this has not been the general rule.

#### IV. CONCLUSION

Without discussing other areas of law that affect petroleum subcontractors, *e.g.*, regulations with regard to the Nor Peruano Pipeline which only directly affect a small number of companies,<sup>105</sup> and varying labor law dispositions<sup>106</sup> which were in existence prior to

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102. *Id.* art. 2.

103. Peruvian Times, *Peru Petroleum Survey 1974*, Sept. 20, 1974, at 42.

104. See Clause VIII of any of the "Model Contracts," note 17 *supra* and accompanying text.

105. See Decree Law No. 19435 of June 6, 1972 (declared of necessity and public utility, with the highest national priority, the construction of a Transandean pipeline), and Decree Law No. 20538 of Feb. 26, 1974 (pipeline construction and importation and exportation regime for subcontractors involved).

106. See the following regulations regarding the number of foreigners who can work for a company in Peru: Decree Law No. 14460 of April 25, 1963; Decree Law No. 14570 of July 9, 1963; Supreme Decree No. 017 of Sept. 7, 1964; and, Supreme Decree No. 004-72-TR of April 11, 1972. The general rule is a maximum 20% foreigners on a company's payroll, both in aggregate amount of salary and in

the present wave of oil exploration, it can be concluded that the regulatory dispositions concerning petroleum contractors and sub-contractors have greatly expanded during the last five years in order to accommodate a new industry in Peru. Moreover, both administrative and court interpretations of existing regulations have been necessary to insure that the laws and their regulations will be applied fairly to the interests of both the subcontractor and the State, permitting business efficiency on one hand, and allowing government regulation of new entities and fiscal revenues on the other.

*Editors' Note:* By Supreme Decree No. 029-76-EM/DGH, published in the official newspaper El Peruano, on July 21, 1976, the Peruvian government announced that petroleum areas would be again available for petroleum exploration and exploitation, both in the jungle areas and offshore. These areas will be available under operations contracts with the State, and there also exists the possibility to carry out secondary recovery operations in the oil fields of La Brea y Parinas, Lobitos, El Alto and Los Organos. No operations contracts have been granted since mid-1973.

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number. Decree Law No. 14460 of April 25, 1963, art. 2. Certain exonerations exist to this regime, and foreigners married to Peruvians or with children born in Peru are not counted in the calculation. *Id.* art. 3.