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Analysis of Michelle Bachelet's Tax Proposal: Small and Medium Businesses (PYMES) and Internal Revenue Service (SII)

Michelle Bachelet's tax proposal, which aims at strengthening the Internal Revenue Service (SII) in order to prevent tax avoidance and tax evasion, is based on tools that are least debatable. Other measures qualified as pro small and medium businesses (PYMES), which point at simplifying their tax system, might result restrictive and they do not entail a significant advantage in relation to the proposed general regimen.

In the last Public Issues delivery, we analyzed the main features of the tax reform proposal presented by the New Majority's presidential candidate Michelle Bachelet. In the document, we referred to the proposals that we believe will have a deep and negative impact on savings, investment and growth. In this edition, we will analyze, from an economical and legal perspective, her other proposals aimed at giving more powers to the Internal Revenue Service (SII), and assumingly benefit the small and medium businesses (PYMES), and other initiatives regarding specific taxes.

Proposal: Reforms to the SII – codification of a general anti-avoidance rule

Michelle Bachelet's document on tax reform proposals states the following: "In recent years, the SII has suffered stagnation in its modernizing process, and it has even taken a step backwards in key areas, such as auditing and technological investment. The consequence has been an evasion rate increase, at levels higher than 20% for the VAT, being at 10% in the last decade, a figure comparable to that of developed countries with the best tax compliance".

Based on this premise, the candidate justifies the measures to be adopted, among others, to strengthen the SII. It is worth analyzing this measure that would incorporate a general anti-avoidance rule to the Tax Code, which would allow penalizing taxpayers who adopt this practice "only for tax

reasons and not for the nature of their economic activity, as well as tax advisers who collaborate in tax avoidance activities".

Concerning the central argument, it is necessary to mention that, according to the figures of the Ministry of Finance and the Internal Revenue Service, evasion has been reduced in the last years. By May 2012, the VAT evasion rate had dropped three points, reaching 20% (from 23% at the end of Bachelet's government), accumulating higher fiscal revenues for US$615 millions and a total of US$1,247 millions, including the VAT effect and the Income Tax.[i]

The above figures show the relevance of making continuous efforts to fight evasion, since it restrains the State's collecting capacity and the development of public policies to be financed with those resources. Minimizing fraud and fiscal evasion is a real alternative to tax increase, because the Public Treasury would collect extra revenues on this concept. In order to fight evasion, literature and experience point out that two main dimensions have to be dealt with: the auditing action, together with the penalties embraced in the tax legislation, and the simplicity of the tax structure.[ii]

In relation to auditing, a good public policy should tend to incorporate greater technology, and control and information tools for the auditor. In penalty matters, the latter should be serious enough to inhibit the evasion behavior, and it is essential that its application is not separated from the perpetration of the infraction so that a dissuasive effect is produced. In turn, measures aiming at reducing opacity and favoring more efficient information exchange and administrative collaboration (with due safeguard of individual rights and data), cooperate with the auditing task of the tax administration. Concerning simplicity, the tax structure's greater complexity – for example, in the way of different taxes, exemptions, special treatments, concessions – can obstruct the authority's auditing action.

However, we believe that evasion should not be confounded with avoidance, understanding the latter (with reference to taxes) as legal and rational conducts, such as abstention and tax savings, whose aim is to prevent the configuration of a taxed event or make one with a lesser tax burden.[iii] Candidate Bachelet proposes to codify a general anti-avoidance rule with a technique known as the doctrine of the "economic substance over form". This would allow penalizing transactions made with simple tax purposes and not for economic reasons.[iv] This means to leave out the legal act when it comes to qualifying businesses or operations, in order to search for its real economic motivation. Thus, its purpose would be a detailed analysis of the transaction's real objective, in such a way that the operation would be considered valid for tax effects if it produces economical benefits for the parties, in addition to a fiscal effect or without it.

The proposal is very complex and highly questionable. Given its difficulty, a rule with these characteristics[v] would not distinguish those who abuse of the legal rules from those who are just legitimately making a rational use of the available tax instruments, thus generating a non-desirable indefinition. The dilemma is focused on determining if the application of different legal structures by taxpayers is an anti-juridical conduct or not;[vi] there is a value judgment concerning the law in force in the sense that people do not seem to pay the taxes that the SII considers they should pay.

This type of rules is generally structured by inversing the burden of proof, transferring it to the taxpayer, who is responsible for proving his good faith. This alters the general rules of our legal system and it turns out an extremely onerous burden. Due to the indefinition we mentioned earlier, there is also a juridical uncertainty creating immobilization in transaction, business and investments matters that are the tax generating source, which can even end up reducing collection. Any form of legitimate tax planning entailing savings can end up becoming an anti-juridical action. The truth is that no one is forced to choose the most onerous alternative for his interests, and the judicial practice of different countries has stipulated the right of taxpayers to choose the legal forms that are more beneficial to them from the taxation point of view.[vii] On the other hand, when legislation is changed to put an end to tax avoidance (negatively understood), another effect may occur, that is, a tax burden increase, on the ground that a tax is being extended to facts which were not legally taxed. We might also mention that this type of rules give an enormous power to the tax authority.

People who abuse of this right should be penalized, and effective solutions to discourage these behaviors should be found. However, it is imperative that the analysis considers a comprehensive view of all the objectives and principles that are sought to be safeguarded, with the purpose of incorporating solutions that do not adversely affect other equally desirable legal or economic goods.

“Pro-PYMES” Proposal

After the first announcement of candidate Bachelet regarding the rise of the First Category Tax, there was concern about the effects of such a measure on PYMES. Concern grew when the tax proposal on accrual basis aimed at shareholders was added, which is known as the FUT elimination (Fund of Taxable Income). If these measures are implemented, PYMES shall have to increase resources to pay taxes, thereby losing liquid assets, and having to look for financing to pay working capital and financial liabilities. If these resources were obtained through indebtedness, they would additionally be subject to higher rates of tax and stamp duty, according to the candidate’s proposal. Given this scenario, her proposals included the following assumingly pro-PYMES measures:

- To extend present article 14 ter of the LIR (Income Tax Law – simplified tax system) to all companies with annual sales lower than 14,500 UTM, either individual businesses or juridical persons, and regardless of their VAT liabilities. This proposal would go hand in hand with the elimination of the regimes included in the 14 bis, 14 quater and that of presumptive income.

- Change of subject for VAT payment, so that large companies, which make credit purchases to their suppliers (PYMES), will be responsible for paying a proportion of the VAT corresponding to these operations.

In brief, article 14 ter offers the following advantages: immediate deduction of investments and inventories as spending; cost savings due to a simplified accounting; and a 0.25% fixed PPM rate (*pago provisional mensual* - provisory monthly payments) imputed to annual gross sales.

In spite of extending the application threshold of article 14 ter and the number of taxpayers who are subject to resort to it, it seems a simplification purpose of our tax system rather than a benefit for PYMES. In the first place, the proposal invalidates the current regimes which allow small taxpayers to make their tax burden less onerous, thus limiting their freedom of choice, and the proposed regimen is not necessarily a perfect substitute of the other ones. For example, article 14 quater of the LIR (intended to be eliminated) allows an exemption of the First Category Tax for incomes up to 1,440 UTM. Additionally, article 14 bis, which would also be eliminated, gives the possibility of paying the First Category Tax only if withdrawals are made in the company. Although the 14 ter is an attractive regime, if in the end a regimen of immediate depreciation applicable to all businesses is set up, "in replacement of the FUT", it would seem that the 14 ter would lose this attractiveness, at least concerning this aspect, from the moment the instantaneous depreciation regime is available for all businesses. Although it is positive to extend the limit of article 14 ter to 14,500 UTM[viii] and the number of persons who may resort to it (still uncertain), it seems to be based on including the other companies which would have to migrate from the currently in force regimes (the 14 quater's limit is higher than 28,000 UTM), even though they point at different objectives.

The proposal concerning the change of subject for VAT payments seeks to solve the financial problem of small suppliers (due to the invoice payment mismatch) on occasion of this payment. However, several questions arise. PYMES are subject to VAT, they pay the VAT (debit) on their sales, and benefit from the VAT credit associated to supply purchases. With the proposed change of subject, which is partial ("it will be for a proportion of the VAT"), how will the PYME use this associated credit? Will the PYME be allowed to use it immediately? From the credit's total or the part that was proportionally transferred? In order to actually relieve PYMES, such a

mechanism should be provided for but the proposal is completely silent in this respect. Moreover, even if these points were clarified, it is naïve to assume that the whole financial benefit derived from this change of subject will be entirely used by the PYMES. The obligation imposed on large companies will no doubt lead to a renegotiation of the contracts with their suppliers. Therefore, it is not obvious a priori which would be the real benefit of the measure for PYME suppliers.

Other tax measures

- **Environment:** "As a way of discouraging the purchase of private vehicles using diesel oil and those with high cylinder capacity, we propose to apply a tax proportional to the purchase, which would be paid on a yearly basis together with the circulation permit, differentiated by type of fuel", indicates Bachelet's proposal.

Applying a tax to the cylinder capacity does not seem relevant. Engines with higher cylinder capacity generally use more fuel and, consequently, they are already subject to higher taxes. In fact, if the objective of the tax is to fight contamination and not other externalities derived from the use of vehicle fuel, probably the most adequate additional tax should be associated to the vehicle emission levels and not with their cylinder capacity, since this is only one of the factors to consider as a proxy of the environmental externality of every vehicle (technology and age would also be possible factors). Applying additional rates on the cylinder capacity would be equivalent to imposing a tax on luxury, which would not be aligned with the proposal's objective, and it would mean a step backwards in our tax system, since this tax was already eliminated on account of its lack of rationality.

What would seem reasonable is to level the specific taxes on diesel and gasoline, considering that their negative externality is quite similar. The specific tax on diesel should not have a lower rate than gasoline, and both should be equaled in at least the current 6 UTM per cubic meter of gasoline. Additionally, there should be no rebates for load transportation, since there is no justification at all for this special treatment in terms of externality; and although it is naturally transferred to the transport cost it is right to do so, and production supplies should reflect the real cost they impose on the society.

- **Tax on diesel oil**: The proposal states: "The use of diesel oil in the industrial sector generates negative effects due to the contamination it produces. Therefore, the diesel tax rebate for the industrial sector shall be eliminated. This measure will also be applied as a way of encouraging a change towards clean technologies. This modification shall not be applied to PYMES."

In line with the environmental objective, it makes sense not to make exceptions, neither with trucks or industries. Nevertheless, it should be recalled that the latter have taken mitigation and compensation measures with the aim of obtaining their respective environmental approvals, so they have already taken charge of the cost of their externalities. The ideal scenario would be a fuel consumption tax system associated to the contamination produced by their use, with no exceptions or privileges that benefit certain activities above others. However, if there is a further objective of avoiding traffic jams and financing investments on roads and highways, it makes sense that a proportion of the tax is reimbursed to the industries that do not generate this damage.

- **Corrective taxes:** "We propose to replace the current tax on alcoholic beverages by a specific tax equal to 20 UTM for every 100 liters of pure alcohol included in each type of beverage. This rate is in line with the average of the OECD countries. Furthermore, we propose to replace the current tax on cigarettes by a specific tax on quantity, which maintains revenues at the same level. The measure is a clear discouragement to consumption and it is a way of contributing to public health from the tax perspective", indicates the candidate's proposal.

Taxes on alcohol and tobacco should be considered beyond its collection capacity, as instruments to reduce its consumption considering the externalities they generate.

The need to impose a tax on alcohol is dependent on the externalities caused by its consumption. According to data from the World Health Organization (WHO), the average consumption of pure alcohol in Chile, contained in different proportions in alcoholic beverages, is 8.6 liters a year for older than 15 years, quite above the world average. It is a well-conceived measure, since the tax applied on alcoholic beverages must be conditioned upon the component that generates the externality. Thus, it should be a fixed amount of money per mass or volume of pure alcohol contained in the drink. This unit tax, compared with the tax ad valorem applied today, prevents the possibility of making substitutions towards lower-quality alcohols; higher price products are not excessively taxed; and there is a direct relationship between alcohol content and tax, something which is barely seen in the current system, where wine and beer are subject to an ad valorem rate of 15% and drinks with higher alcohol contents to a 27% rate.

Arguments to impose a tax on tobacco are different from those of alcohol: in relation to the externalities, concern is put on passive smokers and, and to a certain extent, on smokers themselves. In connection with the addiction and irrational behaviors, emphasis in put on young people since they show greater elasticity than adult smokers, and the high persistence of those who acquire the habit when they are young. Finally, the extremely

low elasticity of addicted adults makes them ideal candidates in terms of collection, but from the public policy point of view it does not seem reasonable. The extent of the negative externality is related to the number of bought cigarettes and not with their cost; therefore, a unit tax per pack or number of cigarettes would be the most adequate. The tax imposed in Chile is practically ad valorem in its entirety, and it was only through the Law 20,455 that a slight fixed component was introduced, of 0.0000675 UTM per cigarette (approximately 2.7 Chilean pesos per unit in January 2010), which was increased again to 0.000128803 UTM (5.15 Chilean pesos) per cigarette through the Law 20,630 of 2011.

The WHO calculated the contribution of all taxes levied to the retail price of the most popular cigarette brand for a series of countries in 2010. For Chile, a 76% rate was estimated in line with most developed countries and higher than the OECD 73% average. Consequently, and due to the lack of clarity concerning the extent of the externalities generated by cigarettes, it would seem that the current level is within a reasonable range, and therefore migration should be applied towards a unit tax per cigarette or pack which maintains the tax level.

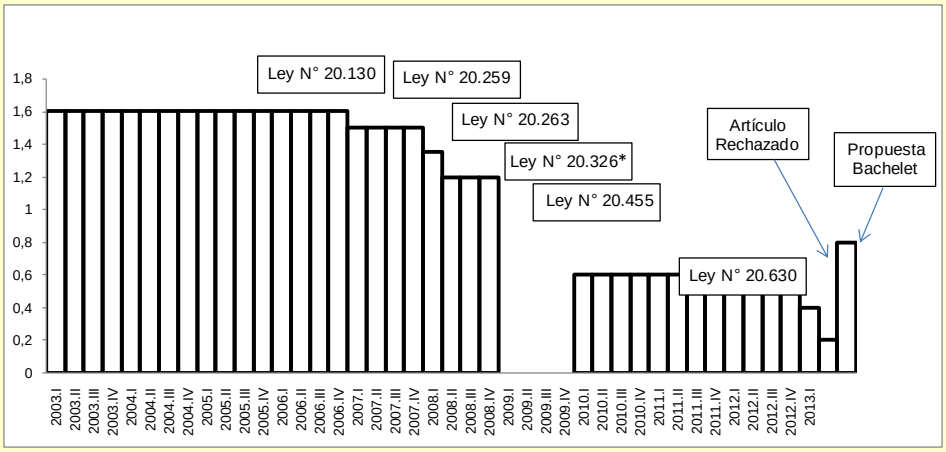
- **Stamp duty:** "We will raise the stamp duty, within a two-year term, from 0.4% to 0.8%. The current situation is maintained for PYMES, which can recover the tax by deducting it from their monthly VAT payment", indicates the proposal.

It is considered an anachronic tax, which was originated as an additional revenue source and makes credit operations more expensive for businesses and individuals. It was been reduced over the last years and it seems nonsense to increase it again, thus it is considered a negative measure. Moreover, a bill (Bulletin 8874-05), which is undergoing the first constitutional proceeding and also establishes the mandatory use of electronic invoice, aimed at reducing it even further, and although the pertinent article was rejected, it has been announced that the Executive will restore it. Chart 1 illustrates the abatement of this duty.

- **Standard exemption of returns:** "People will be exempted from paying taxes on earnings received by savings made in financial instruments, with a ceiling corresponding to returns of risk free instruments, thus rewarding savings to which middle income people normally have access to".

Chart 1

STAMP DUTY BEHAVIOR



Source: Prepared by L&D based on the Budget Laws.

A way of encouraging individual savings, taking into account the existing distortions and aligning, although timidly, individual taxes with a consumption-based tax, is by considering an exemption of returns derived from individual savings. This would be positive, but it has too many restrictions, since it only includes the risk free return, impairing the alternatives of greater returns and risks, on which people actually save. Therefore, although the intention is correct, it would constitute a rather limited incentive. For example, if we consider Central Bank bonds in UF for a 10-year term (BCU-10) as “risk free rate”, and the fact that now the taxpayers’ compulsory pension savings are not part of the tax assessment base, this exemption would be applied only to the non-pension portion of savings.

In brief…

- Minimizing fraud and fiscal evasion is a real alternative to tax increase, because the Public Treasury would collect extra revenues on this concept. However, the proposal is very complex and highly questionable. A rule with these characteristics would not distinguish those who abuse of the legal rules from those who are just legitimately making a rational use of the available tax instruments, thus generating a non-desirable indefinition.
- PYMES shall have to increase resources to pay taxes, thereby losing liquid assets, and having to look for financing to pay working capital and financial liabilities. If these resources were obtained through indebtedness, they would additionally be subject to higher rates of tax and stamp duty.

[i] VAT evasion also reduces the amount of declared earnings and, therefore, the tax base of the First Category Tax. Consequently, it is estimated that for every CLP$100 of VAT evasion, CLP$89 of income tax evasion is produced at a rate of 17% (applied in 2010) and CLP$105 at a rate of 20% (in force in 2011).

[ii] Other factors are the tax administration's efficiency and the acceptance of the tax system (destination of the taxes, moderation of the burden, etc.)

[iii] In this perspective, we distinguish it from deceitful behaviors whose aim is preventing the establishment of a tax liability, thereby resorting to legal evasion (*fraus legis)*, abuse of law or any other illicit means which do not constitute a breach or offense.

[iv] Recently (2010) and for the first time, an anti-abuse general rule was incorporated to the Tax Code of the United States, whose purpose was to standardize the jurisprudence concerning this matter. However, the reform ended up embodying one of the most extreme versions of the substance over form doctrine, on the ground that fiscal benefits of the operation will not be applicable if the operation has no economic substance and lacks a business purpose (store of tests).

[v] Our tax legislation envisages some legislation on the matter, some of them classified by the doctrine as anti-evasion or anti-avoidance rules (at doctrinary level, its qualification as rules against evasion or against avoidance is questionable). In any case, regulation is specific and case by case. Among others, we can quote Art. 64 of the Tax Code, on assessment of the tax base, where the legitimate business reason is set up as a figure of special characteristics; the regulation concerning transfer prices in the LIR, where transactions at "standard market prices" are mentioned, or the "thin capitalization rules", also from the LIR, etc. Something similar occurs with the rules issued in the light of the International Double Taxation Agreements, for example the SII Form Letter Nr 57 of 2009.

[vi] The resolution stating that essence shall prevail over form is a creation of the North American jurisprudence of the thirties. It is an anti-avoidance jurisprudential technique typical of common law systems. This theory has been embodied by some Continental Europe countries, like France and Germany, especially in matters related to International Double Taxation Agreements.

[vii] In the Chilean case, it is possible to review the Supreme Court decision "Sociedad Bahía Mansa con SII", case Nr 4038-2001.

[viii] Today at 5,000 UTM.