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Tax Reform: The Difficult Route of the Bill that was Unable to Close the Discussion

The approved tax reform will collect approximately one billion dollars per year within a structure where corporate tax is increased and individual tax and tax on loans are slightly reduced. No matter how praiseworthy the purpose or destination of the collected revenue, the truth is that it was motivated by political rather than strictly public finance reasons.

The Government finally managed to pass the controversial tax reform this week. After intense negotiations at the mixed commission formed to solve the differences between the Chamber of Deputies and the Senate –after refusing the idea of legislating in the latter-, and where at moments it seemed that the bill would be turned down, the Government reached an agreement with parliament members of the *Concertación* and la *Alianza* to carry forward the legal proposal. This agreement was ratified on the following day by the boardrooms of the Chamber of Deputies and the Senate, thus the bill being ready to become a law of the Republic.

What occurred in this long negotiation journey was actually the reflection and consequence of the proposal's difficult lead time and proceeding, first, within the government coalition and, afterwards, in its Congress sessions. We should not forget that the first bill introduced by the Executive in May was withdrawn from proceeding after three months of arduous debate and multiple criticisms, both political and technical.

Later on, in August 2012, the Executive introduced a new bill or simplified version of the former, insisting on the structure of tax increases and reductions and "tax improvements", and after a month of additional debate it was unable to achieve the required support at the Congress either. This bill, which is very similar to the one passed by the Congress, maintained the first category tax increase; this measure, as we have repeated in several previous publications,[i] has a negative impact on growth, especially for the medium and small businesses' (Pymes) segment, particularly due to the retroactive character of the same. Furthermore, the bill eliminated the controversial "green tax" and the tax increase for alcohols, and it did not

include other measures, very desirable in our opinion, such as the gradual tariff reduction –given the competitivity advantages of our country and the benefit for consumers- and the reduction to 0.2% of the stamp duties, which was finally accepted but with a 0.4% rate, thus lesser contributing to reducing the cost of loans. After successive indications at the Chamber of Deputies, the bill underwent additional changes after which it was decided to eliminate, for political reasons, the rate reduction for the Second Category and Complementary Global taxes for the higher income bracket; actually, this rate is high compared with the OECD member countries and other countries of the region. Additionally, the treatment of private investment funds was regulated through a very questionable parliamentary indication as to its receivability, due to its clear tax effects. The latter was not included in the Executive's bill which was finally passed by the National Congress, so that private investment funds are not part of the motion which is now ready to become a law.

Concerning the so-called tax improvements, the bill introduced in August did not incorporate the changes originally proposed for article 64 of the Tax Code on assessment authorities; nor the changes to the Income Tax Law on excess withdrawals of the taxable profits fund ledger (FUT, *Fondo de Utilidad Tributario*), reinvestment withdrawals, or the rules on excessive borrowing. Although such modifications were introduced to cope with a diagnosis that was shared up to a certain point, the truth is that the proposed solutions gave too much discretionary authority to the Internal Revenue Service (SII, in Spanish); they infringed principles of the greatest importance to our taxation system, which have fostered growth in our country, and had an adverse effect in terms of biasing our companies' investment decisions and those regarding access to financing. The other tax improvements were maintained in the proposal and were later repeated in the bill passed by the mixed commission and the National Congress; some of them with changes in a positive direction with regard to the original proposal of May (although not exempt from other difficulties); others, with certain modifications upon which it is hard to venture a diagnosis today in relation to its eventual merits, as it occurs with the rules proposed for the treatment of refused expenses and, finally, other improvements which were kept in identical terms, some of them still deserving technical observations.

Nevertheless, all these changes were not enough to lead the Senate to approve the idea of legislating on the reform, so the proposal ended up being informed at the mentioned mixed commission, which finally gave the green light to the bill presented by the President and which is detailed below.

Does the Government "win" the battle? Is it able to close the tax discussion?

We could maintain that the evaluation of all this tax discussion is, politically speaking, positive for the Government. It finally gets to unblock a motion

that had been introduced with no major conviction (it is impossible not to mention that it was imposed by the street uproar, the students and a *Concertación* which adhered to this idea in the framework of the discussion and approval of the Budget law for 2012), but paradoxically, it shall be remembered as “the” economic proposal of this Administration, which agreed a solution with the opposing parties in a particularly complex context. Thus, the Government manages to resume the way of consensus. However, from another perspective, the analysis is less optimistic, due to the persistent concerns of the effects of this reform on growth, saving, the PYME segment- a great supplier of employment sources and engine of entrepreneurship-, the investment attraction and the real need of promoting it. It is never redundant to insist on this point: it is extremely concerning that the tax system becomes “THE” tool to be revised and modified every time additional resources are required. Needs will always exist, and first-rate ones, but it does not justify nor makes it recommendable to submit our tax system to a permanent revision and still less in a scenario which seems determined to increase public expenditure and get the State to excessively grow.

The passed bill, although endorsed by most of the members of the opposition, has nevertheless been considered insufficient, so it seems today that the tax debate will remain open and that this law and its discussion will be only the forerunner of a bigger tax argument in view of the next presidential elections. Thus, it is highly probable that different ideas set out on occasion of this reform will be raised again, in addition to many others. Considering this scenario, we only need to wait and act accordingly, and in honor of the juridical and economical certainty and the signals we want to send as a country, may the debate’s seriousness be preponderant, and principles inspiring our tax system, such as neutrality and the integration of taxes, are not transgressed, since they are transversally recognized as the pillars which have taken our country to its current growth and investment levels. But all these achievements should not be taken for granted. While recognizing that all systems and legislations are improvable, and that they have to be reviewed from time to time in order to evaluate the pertinence and permanence of its provisions, incentives and structures, we should not forget that there is still work to do to achieve the much desired development, so it seems that this is not the time, and the truth is that it is never the time, to make risky bets or easy speeches on tax matters.

Main contents of the President’s tax proposal which finally became a Law

The bill passed by both branches of the National Congress is structured as follows:

1) First Category Tax increase and changes in the tax on tobacco

Since the bill passed by the National Congress introduces no changes on this matter, in relation to the proposals presented by the Executive in May and August, we shall quote the essence of what was previously said on this subject.[ii] However, it is still worth highlighting our concern regarding the measure's retrospective effect. According to the Financial Report of the approved proposal, the additional revenue for 2013 by way of increasing the First Category Tax rate amounts to US$1,796 millions. The higher revenue for 2013 is because the advance monthly payments (PPM, in Spanish) made on the 2012 sales have been calculated with a tax rate of 18.5%. Thus, this additional 1.5%, which has not been monthly paid through the PPMs, is reflected upon the income tax return check 2013 (*Operación Renta 2013*) as a greater revenue. Approximately US$1,100 millions represent the higher rate, while the remaining US$700 millions represent the provisioning difference. If we take into account that approximately 16% of the sales made by all companies are made by a Pyme (less than 100,000 UF annual sales) we may conclude, in a general way (assuming similar margins in Pymes and large companies), that close to US$100 millions (of the US$700 for less provisioning) will be paid by Pymes. This will probably generate a greater pressure on Pymes, especially in the first half of 2013, and particularly in a downward-trend context of global economy, a deceleration of domestic demand and projections of a moderate access to loans. Considering the extraordinary incomes that will be obtained in 2013 as a consequence of the CODELCO-Anglo-American operation, and that the information we have suggest that it is not evident that First Category Tax retroactivity is a *sine qua non* condition for fiscal stability, the measure could have simply been designed to prevail for the incomes received or accrued as of 2013.

Regarding the tax change on tobacco, where *ad valorem* tax is reduced and the portion corresponding to the specific tax is increased, we believe the measure is positive. In this type of goods, it is preferable to have fixed amount taxes over *ad valorem* taxes in order to charge the externality which accounts for the consumed amount and not necessarily the price. On the other hand, this is consistent with the trend observed in developed countries, where they have decided in favor of fixed amount taxes. An *ad valorem* tax may even have negative effects, since it generates greater substitution towards cheaper cigarette brands, which generally have more harmful components for health than the more expensive brands. Therefore, this modification strengthens, in the right direction, the change introduced by the Law for Financing Reconstruction which added the fixed component per pack of cigarettes.

2) Tax reductions, tax reliefs and others

The bill passed by the National Congress indicates the following on this matter:

a) Rate reduction on the Second Category and Complementary Global taxes, for all brackets, except the last one for incomes above 150 UTM/UTA[iii] (depending if it is Second Category or Complementary Global Tax), which is maintained at a 40% rate.

Thus, the approved bill increased the rate reduction for the lower brackets and delimited the reductions originally proposed for the higher brackets. Of course, since we have a progressive system, the infra-marginal rate reductions also favor higher income taxpayers by reducing their average rates.

Reducing individual taxes stimulates work and the formation of human capital, minimizing the distortions generated by taxes in the decisions concerning work versus leisure. Moreover, the reduction of the maximum marginal rate is in line with the compared experience, so that reductions are a positive signal for our country's development. Although it would have been highly desirable for the Government to maintain its original proposal of reducing rates in all brackets, giving a step towards a rate reduction is certainly a positive point and it adjusts to the trend of the OECD countries.

Table 1

INDIVIDUAL TAXES RATE REDUCTION

Bracket	Taxable Income UTA) (*)	Current Rate	May-August Bill	New Approved Rates	Marginal Rate Reduction
1	Up to 13.5	0%	0%	0%	0%
2	13.5 to 30	5%	4.25%	4%	-20%
3	30 to 50	10%	8.75%	8%	-20%
4	50 to 70	15%	13.50%	13.50%	-10%
5	70 to 90	25%	22.50%	23%	-8%
6	90 to 120	32%	28.80%	30.40%	-5%
7	120 to 150	37%	33.30%	35.50%	-4.10%
8	150 & over	40%	40%(**)	40%	0%

Source: Prepared by LyD.
(*) UTM for Second Category Tax.
(**) The new bill introduced in August envisaged leaving this income bracket with a 36% rate and the creation of a "super bracket" for incomes above 260 UTM/UTA with 40% rate. However, in the proceeding at the Chamber of Deputies, this new bracket was eliminated, and the bracket of 150 UTM/UTA returned to its original 40% rate.

b) Redetermination of the Second Category Tax for employed workers whose salaries vary during the year. This is a positive measure, since it corrects an unjustified asymmetry in the current Income Tax Law between taxpayers of this tax and those who pay Complementary Global Tax.

c) Credit against personal taxes for school and preschool expenses. This point will be dealt with further on in the "education keystone" of the approved bill.

d) Reduction of the stamp duty from a 0.6% to a 0.4% rate.

e) Exemption of the additional tax in the case of payments made abroad for software use licenses.

f) Elimination of the tax on motor homes: the 15% tax surcharge to the first purchase of self-propelled motor home vehicles is eliminated.

g) Extension of the term for the Treasury to grant payment arrangements for owed taxes, extending it up to a maximum of 36 months, insofar as they are taxes collected up to June 30th, 2012 and that they are subject to judicial and administrative collection; taxpayers are entitled to this benefit up to 90 days after publishing the law in the *Diario Oficial*. This measure benefits the Pymes, among others.

h) Maintenance of the bonus for taxi and school bus drivers.

3) Other amendments to different rules of the Income Tax Law ("tax improvements")

Table 2

OBSERVATIONS ON THE MAIN TAX IMPROVEMENTS[iv]

Rules on transfer prices	The proposal adopts the rule prevailing in the international practice (OECD), seeking to authorize the Administration to exert greater control on transactions with related parties, transnational companies, while giving more certainty to taxpayers.
Treatment of refused expenditure	A single 35% rate tax is envisaged for partnerships and stock companies. When refused expenditures are ascribed to a partner, the object of expenditure shall be taxed at the partner's level with the Complementary Global or Additional Tax, increased by 10%. Anyhow, disbursements can be deduced as necessary expenditure. Although the rule represents an improvement with respect to May's original proposal, it is not clear that the approved solution is better than the one envisaged in the current Income Tax Law, particularly for the Pyme sector.
Treatment equalization of	The major difficulty is that the possibility of deducting interests is not expressly regulated regarding the

stock rights and actions in terms of their purchase cost and tax effects of their transfer to stock company rules	purchase of shares or stock rights; today, under the prevailing SII criteria, it is not possible to deduct interests derived from investing on shares. Now, the same problem will arise in relation to stock rights, thus originating non-desirable uncertainty and judicialization.
Source rules or regulation of indirect sales, abroad, Chilean underlying assets and their tax	The bill passed by the Congress, although it contains important improvements regarding the original proposal of May 2012, when approaching compared legislation on the matter and providing for an authenticity rule of the Chilean underlying asset in the foreign asset to be sold (20%) and require that at least 10% of the foreign asset is transferred in order to trigger the rule. However, in addition to the fact that its wording is not very clear, it presents the following objections: • It provides for a low authenticity rule compared with international experience (case of Peru, Canada, Australia, 50%), which makes our legislation less attractive as investment platform. • It includes absolute value hypothesis of the underlying asset with no relation to the foreign asset being sold, disregarding the authenticity criterion to impose a tax on the operation. • Even though the current rule could be improved, the truth is that considering its political impacts and in terms of attracting investments, the amendment required further study.

Source: Prepared by LyD.

4) Education Keystone

a) Credit against tax for education expenses: the proposal delivered by the National Congress envisages a credit against the Complementary Global/Second Category Tax for presumed expenditures on education up to CLP$100,000 per child for families with a maximum monthly income of 66 UF, that is, for middle class families.

The law does not distinguish the type of school institution which may apply to this credit, so it is valid for any type of school or preschool institution recognized by the State. Enrollment certificate and minimum attendance percentage (85%) shall be required. The measure will reduce fiscal incomes by US$88 millions in schools with shared financing; US$16

millions in subsidized schools without shared financing; and US$38 millions in municipal schools.

As mentioned above, the measure is positive and recognizes the investment character on education human capital, giving it an equitable treatment with the investment made, in capital assets, by the companies.

b) Education permanent fund indication: the passed bill envisages an education fund, which shall be constituted by one or more contributions derived from the liquidation of assets from the Treasury, including the Social and Economic Stabilization Fund, until completing US$4 billions, which shall be completely transferred not later than December 31st, 2013. Resources allocated to pre-school education, preferential school subsidy and higher education scholarships and credits shall be the preferential uses of the fund's resources.

A Regulation issued by the Ministry of Finance shall fix the mechanisms, procedures, limits and other rules needed for the allocation of the fund's resources, which will be operative as of 2014.

Other Government commitments which are not part of the legal proposal delivered by the National Congress

With the purpose of relying on the Legislative Power's support to the initiative presented by the Government to the mixed commission, the Executive proposed, in a parallel and complementary way, some additional measures; some of them finally became part of an agreement protocol subscribed by the Parliament members and the Executive, and it is nothing else than a commitment between the Government and the Congress to present for discussion at the latter, and soon, the following legal initiatives:

a) Measure aimed at large-scale use of electronic invoice: the purpose of this measure is to modernize the system and reduce VAT evasion, thus increasing the net revenue by around US$400 millions per year.

b) *Fondo de Apoyo al Mejoramiento de la Gestión Educacional Municipal* (FAGEM, fund for improving municipal education management): through this measure, the government commits itself to allocate additional US$34 millions to the FAGEM, annually. This means an increase close to 40% for the FAGEM, whose funds in the 2012 budget come close to CLP$44 billions.

Conclusion

The approved tax reform will collect approximately one billion dollars per year within a structure where corporate tax is increased and individual tax and tax on loans are slightly reduced. No matter how praiseworthy the purpose or destination of the collected resources, the truth is that it was

motivated by political rather than strictly public finance reasons. It also demanded a great deal of time to the Government, the parties of the *Alianza* and the opposition and, at times, it extremely tensioned the relationships among all these actors.

Although positive experiences can be derived, such as making progress in the way of consensuses, which are by the way so necessary in democracy, the lesson is maybe something else: when initiatives are proposed that do not necessarily respond to the convictions of those who promote them, the costs (maybe they are not immediately visible, but they are in the long-term) end up being high, as well as the risks, as a consequence of those initiatives, of other ones being increasingly promoted which are "sufficient" to achieve the proposed goals, and can often be alien to technical motivations and be rather inspired by other type of reasons. In view of the debate that this reform was unable to close, and which is practically taken for granted, we hope that future proposals are made on the basis of serious surveys and analysis, which have been made and will be made on our tax system, and that they seek to improve it with the aim at fostering growth, saving, investment, and employment, all of them foundations of development.

In brief…

MAIN CONTENTS OF THE REFORM:

- Increase of the First Category Tax and structural change of the tax on tobacco.
- Tax reductions, tax reliefs and others.
- Amendments to different rules of the Income Tax Law, called "tax improvements".
- Education pillar or keystone.

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[i] Public Issues Nr 1,074; 1,063, 1,060, among other publications.

[ii] Ibid.

[iii] The UTM (*Unidad Tributaria Mensual*) is a currency unit, expressed in Chilean pesos, that is adjusted monthly in line with the Consumer Price Index. The UTA (*Unidad Tributaria Anual*) is adjusted annually.

[iv] Concerning this point, the passed bill also includes ratio or "contamination" rules in presumed income matters applied to transportation activities; changes in the regulation on capital earning in the transfer of title and possession of real estate; changes to the regulations on advance payments for profits absorbed by tax losses; treatment of goodwill and badwill and taxation rules for agencies in relation to their world-source income.