OECD Economics Department Working Papers No. 1204

Taxation and Investment in Colombia

Sarah Perret,

Bert Brys

https://dx.doi.org/10.1787/5js1pz3d0j8r-en

OECD

Unclassified **ECO/WKP(2015)22**

Organisation de Coopération et de Développement Économiques
Organisation for Economic Co-operation and Development **30-Apr-2015**

English - Or. English

ECONOMICS DEPARTMENT

ECO/WKP(2015)22
Unclassified

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By Sarah Perret and Bert Brys

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ABSTRACT/RÉSUMÉ

Taxation and Investment in Colombia

The Colombian corporate tax system is highly complex and distortive. The effective tax burden on businesses is very high due to the combined effect of the corporate income tax, the corporate surtax introduced in 2012 (CREE), the net wealth tax on business assets and the value added tax (VAT) on fixed assets. Indeed, in addition to high statutory taxes on corporate income, formal sector businesses are subject to a wealth tax on their net assets and to a production-based VAT system under which VAT paid on the purchases of fixed assets is not creditable against output VAT. Calculations in this paper find that the total marginal effective tax rate reaches about 60% for equity-financed investments. Such a high effective corporate tax burden is likely to deter investment and to further encourage tax evasion in the future and therefore calls for a fundamental business tax reform. This paper also reviews the other key elements of the capital income tax system in Colombia.

This Working Paper relates to the 2014 *OECD Economic Survey of Colombia* (www.oecd.org/eco/surveys/economic-survey-colombia.htm)

JEL classification codes: H2

Keywords: taxation, investment, Colombia

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Fiscalité et investissement en Colombie

Le système d'imposition des sociétés en Colombie est très complexe et génère d'importantes distorsions. La charge fiscale effective sur les entreprises est très élevée en raison de l'effet combiné de l'impôt sur les sociétés, de la surtaxe sur les sociétés introduite en 2012 (CREE), de l'impôt sur les actifs nets des entreprises et de la taxe sur la valeur ajoutée (TVA) afférente aux immobilisations. En effet, en plus d'impôts élevés sur les sociétés, les entreprises du secteur formel sont soumises à un impôt sur leurs actifs nets et à un système de TVA selon lequel la TVA payée sur les actifs immobilisés n'est pas déductible. Les calculs dans cet article montrent que le taux marginal d'imposition effectif atteint au total environ 60 % pour les investissements financés par fonds propres. Une telle charge fiscale effective sur les entreprises est de nature à dissuader l'investissement et à encourager davantage l'évasion fiscale à l'avenir et nécessite donc une réforme structurelle de la fiscalité des entreprises. Cet article examine aussi les autres éléments clés de la taxation des revenus du capital en Colombie.

Ce document de travail se rapporte à l'*Étude économique 2014 de l'OCDE sur la Colombie* (www.oecd.org/fr/eco/etudes/etude-economique-colombie.htm).

Classification JEL : H2

Mots clés : fiscalité, investissement, Colombie

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ENCOURAGING INVESTMENT THROUGH TAX POLICY REFORM IN COLOMBIA

By

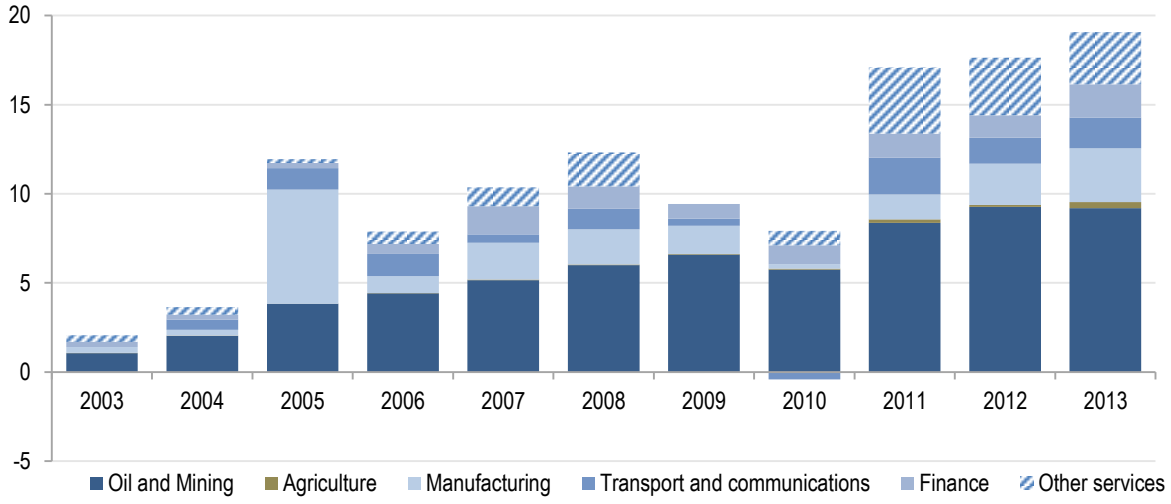
Sarah Perret and Bert Brys[1]

Introduction

Since the early 2000s, Colombia has gradually opened up to trade and investment, has seen an improvement in its security situation and has taken advantage of favourable external conditions. Booming oil and mining investments and exports have in turn led to an increase in domestic demand. Meanwhile, sound macroeconomic policy reforms such as the adoption of an inflation targeting regime, a flexible exchange rate, a structural fiscal rule and solid financial regulation have underpinned growth and reduced macroeconomic volatility. This has also brought social improvements, as the share of the population living below the national poverty line declined from half to a third within a decade.

Colombia is now facing conflicting priorities. On the one hand, it needs to continue attracting additional and more diversified investment. The oil and gas and mining and quarrying sectors have attracted most of the new foreign direct investment (FDI) over the last decade (Figure 1). However, this is unlikely to be sustainable over the long run, as the resource boom is expected to be short-lived. Some estimates have shown that oil production will reach its peak around 2015-17 (Ministry of Mining and Energy, 2012).

Figure 1. **FDI inflows by sector, USD billion**



Source: Banco de la República

Attracting new and more diversified investment will require lowering the excessive and distortive tax burden on businesses. As this note shows, the effective tax burden on businesses is very high due to the combined effect of corporate income taxes, the net wealth tax on business assets and the value added tax

[1] Sarah Perret and Bert Brys are tax economists working at the OECD Centre for Tax Policy and Administration. This paper was originally prepared for the *Economic Survey of Colombia*, published in January 2015 under the authority of the Economic and Development Review Committee. The authors are grateful to Christian Daude, Christine de la Maisonneuve, Alvaro Pereira, Robert Ford, Piritta Sorsa, Michelle Harding, David Bradbury and Tom Neubig.

(VAT) on fixed assets. Colombia will therefore need to lower the tax burden on businesses as part of a comprehensive reform to support investment and economic growth.

At the same time, Colombia is faced with the need to raise additional tax revenues. The budget deficit amounted to 2.4% of gross domestic product (GDP) in 2013 and public sector net debt was around 25% of GDP while total public debt was close to 40% of GDP. While these levels seem sustainable, Colombia's fiscal rule targets an even lower public debt. Meeting the government targets will be difficult without raising additional tax revenues given the expected decline in mining-related revenues and the expiration of the financial transaction tax and the wealth tax. In addition, it is expected that public spending in education, health and infrastructure will need to increase, putting additional pressure on public revenues.

Since tax revenues have to increase but taxes on businesses need to be reduced, a shift in Colombia's tax mix will be necessary. At present, revenues from personal income tax (PIT) amount to only 0.2% of GDP, which is extremely low compared to Latin American countries which collect on average six times more revenues through PIT and OECD countries whose PIT revenues amount on average to 8.5% of GDP. Increasing the taxes that weigh on individuals, including PIT and taxes on personal capital income, will boost tax revenues but also contribute to making the Colombian tax system more progressive and ultimately to reducing the country's high levels of income inequality.

The focus of this background note will be on the taxes that directly affect investment and savings in Colombia. These taxes include corporate income taxes, the net wealth tax, the VAT on fixed assets, as well as taxes on personal capital income. This background note is a technical complement to the *2014 Economic Survey of Colombia* which provides a broader assessment of Colombia's tax system and covers, in addition to the tax areas examined in this note, personal income tax, social security contributions, the general VAT system, environmental taxes and tax administration issues. The analysis is based on the tax system that was in force until the end of 2014 and the tax reform proposals that were announced in October 2014; it does not incorporate the tax changes that were approved by Parliament on 23 December 2014 and which became effective in 2015.[2]

Corporate Income Taxes

Rates

The 2012 tax reform reduced the statutory corporate income tax (CIT) rate from 33% to 25%. However, a new "equity" tax on corporate income, the CREE, was introduced to fund social programmes which were previously financed through payroll taxes (*parafiscales*). The CREE currently applies at a rate

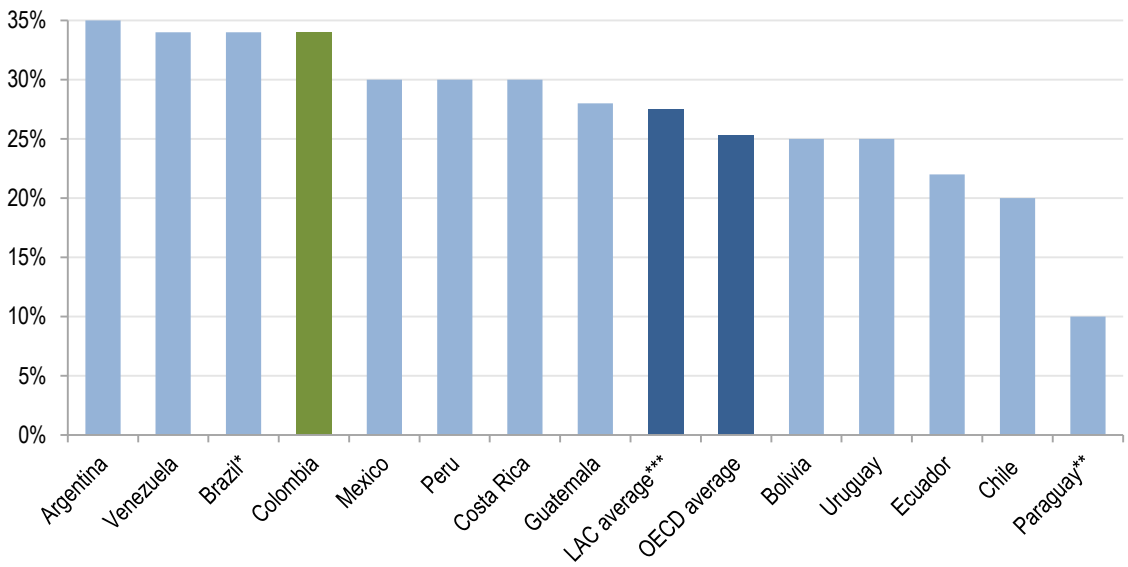
[2] A new tax reform received legislative approval on 23 December 2014. The main elements are summarised here. The tax reform creates a new wealth tax for individuals and businesses, although the business wealth tax component will be phased out over the 2015-2017 period and fully eliminated in 2018. The reform makes the CREE tax rate of 9% permanent; a newly introduced CREE surtax rate will be levied on taxable bases exceeding COP 800 million (approx. USD 341 000); the CREE surtax will be 5% in 2015 and increase by 1 percentage point each year up to 9% in 2018 (the top statutory CREE tax rate will then reach 18% in 2018); changes to the CREE tax base will be implemented as well. The reform also (very) gradually eliminates the financial transactions tax (GMF). From 2015 to 2018, the GMF rate will be 0.4%; it will decrease by 0.1 percentage point per year starting in 2019 and be eliminated in 2022. The reform also introduces a voluntary disclosure programme that induces taxpayers to come forward on a voluntary basis with undeclared assets; a new surtax on the wealth tax will be levied on the value of the voluntarily disclosed assets at a rate of 10% in 2015, 11.5% in 2016 and 13% in 2017. Higher penalties will apply as of 2018. The reform also provides businesses with a tax credit against income tax for two points of VAT paid at the standard rate for the acquisition of fixed assets. Finally, the reform modifies the formula to determine the amount of tax credit due to taxes paid abroad.

of 9%. It was initially envisaged that the rate would be lowered to 8% starting in 2016. However, the Colombian government announced in October 2014 (see footnote 2) that it was planning to raise the CREE rate to 12% for firms with annual profits above COP 1 billion (around USD 500 000) to raise additional revenues.

The combined CIT and CREE statutory rate of 33-34% is above the average for Latin American and OECD countries (Figure 2). This high combined statutory CIT rate in turn leads to burdensome corporate effective tax rates (see Table 3 and Box 1). If the Colombian government raises the CREE rate to 12%, the combined corporate statutory rate will be brought to 37%, well above current rates in Latin America. This could result in raising the total marginal effective tax rate on businesses from 60% to 62% (Table 3 and Box 1).

While corporate taxation is only one of the factors that shape firms' investment decisions, maintaining high statutory and effective tax rates is likely to have a negative impact on domestic and foreign investment (Nicoletti et al., 2007). To reduce the combined corporate tax rate, a decrease in the CIT rate would be more efficient than a cut in the CREE rate as the CIT base is narrower. If the government decides to lower the CIT rate, a gradual decrease could be a good option as the short-term revenue costs of lowering the CIT rate are likely to be high and the benefits in terms of attracting investment and FDI will only arise in the longer run (Steiner, 2014).

Figure 2. **Corporate statutory tax rates in Colombia, Latin America and the OECD in 2014**



* includes 9% social contribution

** surtax for dividends not included

*** average for Latin American countries in the graph

Source: OECD Tax Database (http://www.oecd.org/ctp/tax-policy/tax-database.htm) and KPMG (2014)

Taxable bases

Resident companies are taxed on their worldwide income. Foreign companies and branches of foreign companies are taxed only on their Colombia-source income. The CIT taxable base equals gross income less returns, rebates, discounts, all ordinary costs incurred in obtaining net income and all allowable

deductions. Corporate taxpayers may deduct the costs that are "necessary and proportionate to the activities performed" when calculating their taxable income.

The CREE taxable base is broader than the CIT base. The CREE base is defined as annual gross revenue, excluding, among other items, certain tax-exempt income and capital gains. That amount is then reduced by, among other items, ordinary and necessary expenses, interest and depreciation. However, certain items that are deductible for CIT purposes are not deductible for calculating the taxable base under the CREE. In particular, current or accumulated net operating losses cannot be deducted. This is problematic for entrepreneurial firms or businesses involved in significant new investment whose projects often generate losses in the first few years.

Because of the non-deductibility of losses from the CREE base, the United States (US) does not give a tax credit allowing American businesses to offset the CREE paid in Colombia against their US tax liability. The fact that losses are not deductible from the CREE base means that a tax credit for taxes paid in Colombia could potentially be very costly and trigger a large drop in US revenues. Turning the CREE into a more regular corporate income tax by making losses deductible from the tax base may help solve this problem.

Depreciation allowances

Reasonable values of depreciation arising from the normal wear and tear of assets used in business activities are deductible for CIT and CREE purposes. Depreciation may be calculated under the straight-line method (i.e. depreciation by an equal amount each year) or under the declining-balance method (i.e. greater amount of depreciation in the earlier years of an asset's useful life). Other depreciation systems may be used if they can be justified, provided that prior approval is obtained from the tax administration. The normal estimated useful lives of assets set by regulations are as follows:

Table 1 **Tax depreciation rates in Colombia**

Assets	Useful life
Computers and vehicles	5 years
Machinery and equipment	10 years
Buildings and oil pipelines	20 years

If the daily use of assets is greater than ordinary usage, the depreciation rates mentioned above can be raised by 25% for each additional eight-hour shift of asset use. For shorter additional shifts, the depreciation rates can be proportionally adjusted. This special allowance can only apply to taxpayers using the straight-line depreciation method.

The incentive allowing investors to immediately deduct 30% of their investments in fixed assets from taxable income was abolished in 2010 except for companies that had signed legal stability agreements (i.e. agreements which protect investors against changes that could be introduced in future laws).

Presumptive income tax

For both CIT and CREE purposes, a presumptive income tax system applies to incorporated and unincorporated businesses. The presumptive income system constitutes an alternative method of determining the CIT and the CREE taxable bases which ensures that these tax bases are not lower than 3% of the net assets (assets net of liabilities) that taxpayers held at the end of the previous taxable year. From the total amount of net assets, the asset value of shares owned in national companies can be deducted.

This presumptive income tax works as an alternative minimum tax. Every year, taxpayers must compare the value resulting from the application of the ordinary and the presumptive systems. Should the taxable income calculated under the ordinary system be lower than presumptive income, the taxes are assessed on the latter. For CIT purposes only, if presumptive income is higher than the ordinary taxable income, the difference constitutes an excess of presumptive income, which can be carried forward to any of the following five taxable years and offset against the ordinary taxable income.

The presumptive income system does not apply to small companies incorporated after 2011 during their first five taxable years. If these companies perform their activities in the regions of Amazonas, Guanía and Vaupes, the benefit is extended to ten years. In addition, the presumptive system does not apply to companies in specific activities including utility services as the considerable assets of firms in this sector would lead to excessive tax burdens.

The Colombian presumptive tax system has the advantage of ensuring that a minimum level of tax is paid by taxpayers every year. However, it also poses challenges because it is not based on business income or profits but on taxpayers' net wealth. It increases the complexity of the tax system and raises compliance costs for taxpayers and enforcement costs for the tax administration. It also generates incentives to keep assets undisclosed as net wealth is taxed under the net wealth tax but also serves as the basis for the presumptive income system. Finally, it limits the development of capital-intensive industries and encourages debt-financing.

CIT withholding tax

The standard CIT is prepaid through a withholding tax which is generally higher than the actual tax liability because it is levied on gross earnings. This implies that many businesses are entitled to refunds by the tax administration. However, businesses have complained that there is often a considerable delay in these refunds being made available by the tax administration and that the system generates serious cash-flow difficulties, particularly for small firms. For businesses, it would be better if the yearly withheld tax were aligned with the actual tax liability that has to be paid at the end of the year.

Earmarking of the CREE for social programmes

Revenues from the CREE are earmarked for training programmes by the National Learning Service (SENA), childcare provided by the Colombian Institute for Family Wellbeing (ICBF) and the healthcare social security system. However, in practice, as the total expenditure on these programmes exceeds revenues from the CREE, it could be argued that revenues from the CREE fund the general government budget. It should also be noted that, if the CREE rate was increased to 12%, the additional revenues raised would not be earmarked to any specific programme.

Earmarking gives the government less flexibility in the management of public funds. It also leads to distortions in the allocation of funds, such as overspending on the earmarked objectives. That is why up-front earmarking has generally not been considered good policy practice in OECD countries. However, it is important to acknowledge that earmarking may be useful to ensure that funds are spent on designated objectives and to enhance taxpayers' confidence in how their money is spent by the government.

Corporate Tax Benefits and Special Regimes

Overview

Since 2010, there have been partial efforts to reduce corporate tax deductions, exemptions and credits. The most generous tax deduction in the last decade, which allowed investors to immediately deduct 30% of investments in fixed assets from taxable income, was abolished in 2010. In addition, income that used to be

fully exempt from corporate tax – originating from activities such as tourism and hotel services, the sale of renewable energies, some agricultural activities, publishing, medicine and software development – is now taxed under the CREE.

However, generous incentives and special regimes continue to reduce revenues from corporate taxes and to generate distortions between different types of companies and industry sectors. The incentives and special regimes covered in this section include the CIT exemption for certain activities, the free trade zone regime, the tax allowance for research and development, as well as the special regimes for newly incorporated small and medium-sized enterprises (SMEs) and non-profit organisations.

Exempt income under CIT

Colombia exempts from CIT (but not from the CREE) income arising from certain activities. These activities include:

- Late yield crops planted until December 31, 2014, for a period of ten years from the beginning of production;
- The sale of wind, biomass or agricultural-waste generated energy until 2018;
- Hotel services provided in new or remodelled and/ or expanded hotels built between 2003 and the end of 2017, for a period of 30 years;
- Ecotourism activities for 20 years beginning from 2003;
- Publishing companies devoted to publishing books, magazines, brochures or scientific or cultural collectible series, until the end of 2033;
- New forestry plantations and sawmills;
- New medical products developed in Colombia;
- Software developed in Colombia with protected intellectual property rights, for a term of five years.

Free Trade Zones

Colombia also has a very generous free trade zone (FTZ) regime that was put in place to stimulate investment and employment creation. Businesses located in FTZs benefit from:

- A single 15% CIT rate;
- No VAT and customs duties levied on goods imported into the FTZ;
- The possibility to perform partial processing outside of the FTZ for up to nine months;
- The right to sell goods or services to the domestic economy without any restrictions as long as the custom duties and VAT are paid (on the imports into the regular economy);
- Zero-rated VAT for raw materials, inputs and finished goods sold from the regular domestic economy to a business in the FTZ.

The FTZ regime is complex. There are currently more than 100 FTZs in Colombia. Between 2013 and 2014, 17 new FTZs were authorised and the government is considering the creation of a new FTZ for deep-sea offshore exploration. There are two types of FTZs: *permanent* FTZs and *single-enterprise* FTZs. A permanent FTZ is a designated geographical location in which multiple companies operate and which is managed by an FTZ operator, while a single-enterprise FTZ allows an individual company which fulfils specific investment and job creation requirements to benefit from the tax and customs duty incentives irrespective of its location in the country. In addition, Colombia has *Special Economic Zones for Exports* (ZEEE) for businesses located within a few designated cities; these activities do not benefit from the CIT rate reduction but from reductions in payroll taxes and certain labour surcharges instead. Profits from certain infrastructure projects within ZEEEs are exempt from CIT and CREE.

The FTZ regime creates distortions between companies. For instance, companies in FTZs established before and after 2013 are treated differently: the CREE is not applicable to companies declared as FTZs before December 31, 2012 but applies to FTZs established after that date. In addition, the single-enterprise FTZs create disadvantages for domestic SMEs as these will likely not meet the investment and employment creation requirements to be granted the single-enterprise FTZ status.

There is also evidence that FTZs have been misused by companies. For instance, many activities located in FTZs have been classified as manufacturing when in reality no or only minor transformation activities are carried out. Moreover, the tax administration pointed out the issue of smuggling at the border as Colombia has a special border tax regime. FTZs have also generated opportunities for tax avoidance through the manipulation of transfer prices between businesses inside and outside FTZs. From a tax administration perspective, the FTZ regime has been very difficult to monitor.

Because of the increasing number of FTZs and the irregularities detected by the Colombian tax administration, a change was introduced in 2012 to treat transactions between entities located in the national territory and their related parties in FTZs under the transfer pricing regime. Taxpayers will therefore be required to demonstrate that their transactions with related parties in FTZs comply with the arm's-length principle, meaning that the prices of transactions between businesses of the same group are set at the same level as the prices for similar transactions between independent companies.

Moving forward, Colombia could consider different options to reform the FTZ regime. Fully phasing out FTZs would be very difficult and not necessarily advisable as permanent FTZs can help attract investment. However, abolishing single-enterprise FTZs should be considered as they are highly distortive. For permanent FTZs, the criteria for firms to enter them could be tightened. Efforts should also be made to reinforce the tax administration's control over the operations taking place in permanent FTZs.

Another option could be to reduce the benefits offered by permanent FTZs. In the long run, if the net wealth tax on businesses is abolished and the CIT rate lowered, permanent FTZs could be turned into zones which only provide VAT and customs duty benefits to export-oriented businesses. A common way of providing tariff exemptions on imported inputs used in the production of exports is through a duty drawback scheme. With such a system, tariffs are payable when inputs are imported but are then refunded on the portion of imported inputs used in exported goods (Zee et al., 2002). Export-oriented companies could also be granted VAT benefits in the form of zero-rated inputs. It would not provide exporters with benefits regarding their VAT burden (as VAT on exports is refunded) but would allow them to avoid interacting with the tax administration and limit the cash-flow issues that may result from delayed VAT refunds.

R&D tax allowance

Colombia offers a tax incentive for research and development (R&D). The R&D incentive allows an income tax deduction of up to 175% for investments in scientific and technological projects. This deduction cannot exceed 40% of taxable income, as estimated prior to subtracting the amount invested.

There are a number of issues with the design and implementation of the current R&D tax allowance. First, it is very generous compared to similar R&D tax allowances in OECD countries. Second, it is not well-targeted. The R&D incentive benefits mostly the largest companies as these companies generate most of the R&D and have significant taxable income, which allows them to take advantage of the deduction. The tax provision also provides an incentive for businesses to qualify expenses as R&D expenditure, which reduces CIT revenues and increases the costs of managing the tax provision for the tax administration. The tax provision may also subsidise investment that would have occurred anyway. Finally, the R&D incentive does not necessarily imply that the intellectual property subsidised in Colombia will generate taxable profits in the country later on. The high corporate taxes may induce businesses to transfer their intellectual property out of the country and the tax administration might face difficulties in assessing the arm's length price of these intellectual property transfers.

Various options could be considered to reform the Colombian R&D tax allowance. One option could be to reduce the tax incentive for all companies. Alternative options to maintain the current incentive but to avoid giving an excessively generous benefit to large companies could be to have a tax allowance at a less preferential rate for large companies or to put a cap on the absolute amount of R&D that can be claimed or on the total amount of tax support that a firm can receive. Ceilings and differentiated rates for R&D tax allowances or credits are considered good practice in the OECD to ensure a level playing field between companies (OECD, 2013b).

Reduced CIT rate for newly incorporated businesses

Colombia offers a tax incentive for small companies to become formal and incorporate. Indeed, businesses deemed small (based on their asset volume and number of employees) that decide to incorporate are not required to pay CIT in the first two years following their incorporation and are then subject to a reduced CIT rate for three years (25% of the general income tax rate in the third year, 50% in the fourth year and 75% in the fifth year). These businesses are nevertheless required to pay the CREE.

While reduced CIT rates targeted at certain types of companies are common in OECD countries, they are not very effective in supporting growth (OECD, 2010) and tend to generate distortions. In the case of Colombia, for instance, because there is a threshold to benefit from the reduced rate, businesses have an incentive to remain small or to split up into different businesses. In fact, the National Business Association of Colombia (ANDI) reported that many businesses end up splitting up their activities after year six to qualify as new businesses and remain sufficiently small. The government has introduced anti-avoidance provisions but these rules seem only partially effective in preventing this type of tax avoidance.

As shown in Box 1, the actual impact of this incentive on the effective tax burden that businesses face is relatively limited. Indeed, despite the CIT rate reduction, the total burden of the VAT on fixed assets, the wealth tax and the CREE remains very high for a small business that decides to become formal and incorporate.

Special regime for non-profit organisations

Colombia offers a special tax regime for non-profit organisations. Provided they are devoted to activities of general interest to the country (e.g. sports, education, culture promotion, technological or scientific research, environmental protection or social development programmes), their statutory corporate

income tax rate is 20% instead of 25%. Non-profit organisations are also exempt from the CREE and the net wealth tax. Any surplus becomes exempt from income tax if non-profit organisations reinvest 100% of this surplus in the activities for which they were created (i.e. "same activity" requirement). Finally, taxpayers are entitled to deduct their donations to non-profit organisations from their taxable income under the income tax.

It is very likely that this special regime has been misused as around one company out of five is registered as a non-profit organisation in Colombia. In fact, there has been limited control over the businesses that register as non-profits (e.g. charities, cooperatives, *Cajas de Compensacion Familiar*) and over the activities that they actually carry out. It has also been difficult to define and control the application of the "same activity" requirement for re-invested surpluses.

To address some of the weaknesses of the current special regime, Colombia is considering establishing a single register for non-profit corporations for the entire country. The register would probably be centrally managed, meaning that all non-profit businesses would need to register with the same organisation. The current system allowing non-profit organisations to register with a variety of institutions has made the system difficult to monitor.

The tax administration could adopt different strategies to better detect tax fraud cases related to the special regime for non-profits. First, a number of 'red' flag indicators could be used by the staff responsible for processing and assessing tax returns as well as by tax auditors and investigators. Typical indicators include a high ratio of donation amount to net income, taxpayers who have no history of donating and suddenly start making donations in varying ranges, or information that donors to the same organisation have close work/family/cultural relationships (OECD, 2008). The tax administration could also develop an information-sharing strategy. Detecting charity abuse for tax purposes requires using multiple sources of information, available within and external to their tax authority. This means that effective information sharing between tax authorities, other domestic agencies and law enforcement authorities is crucial to detecting such cases (OECD, 2008).

International Tax Rules

Colombia has introduced significant reforms regarding international tax rules. The 2012 tax reform included a refinement of the definition of the arm's length principle, bringing it more in line with the OECD Transfer Pricing Guidelines. A definition of the concept of permanent establishment (PE) was also introduced and the tax treatment of PEs is now similar to that of branches of international businesses. A 3:1 thin-capitalisation rule, aiming to limit interest deductions was adopted. This rule establishes that Colombian firms must comply with a 3:1 debt-to-equity ratio to be able to deduct interest accrued on any type of loan, whether domestic or foreign and with related or unrelated parties. The reform also included changes to the tax treatment of reorganisations (mergers and spin-offs), changes related to the place of effective management rule to determine the tax residence of a corporation, a clearer definition of "centre of vital interest" to determine the tax residence of individuals, as well as general anti-avoidance rules.

In March 2014, Colombia ratified the *Multilateral Convention on Mutual Administrative Assistance in Tax Matters*, which is the most comprehensive multilateral instrument for all types of cooperation to address tax evasion and avoidance. Colombia has also committed to implementing as an early adopter the new global standard for the automatic exchange of information, referred to as the Common Reporting Standard. The Standard provides for the annual automatic exchange of financial account information, including balances, interest, dividends, and sales proceeds from financial assets, reported to governments by financial institutions and covering accounts held by individuals and entities, including trusts and foundations. It sets out the financial account information to be exchanged, the financial institutions that

need to report, the different types of accounts and taxpayers covered, as well as common due diligence procedures to be followed by financial institutions.

Colombia is considering a number of additional changes to improve its international tax rules including the introduction of controlled foreign company (CFC) rules to deal with companies controlled by Colombian taxpayers which are located in lower-tax jurisdictions, the enhancement of its tax treaty network through more and better designed tax treaties, and the adoption of tax information exchange agreements (TIEAs) with neighbouring countries.

VAT on Fixed Assets

In most countries around the world, VAT is only levied on final consumption. Businesses that purchase goods and services, either from the domestic market or from abroad, pay VAT on their purchases but receive a refund for the VAT paid on their inputs (as long as the goods and services are used as part of the regular business activity). A consumption-based VAT provides refunds for fixed assets as well. In Colombia, however, businesses are not refunded for the VAT paid on fixed assets.

Colombia's VAT system increases the cost of capital for businesses (see Box 1) and strongly discourages domestic and foreign investment (OECD, 2010). It also gives businesses an incentive to buy capital goods from businesses which do not levy VAT on their outputs – including firms that are VAT-exempt or businesses that are part of the informal sector – or from foreign subsidiaries or parent companies at below arm's-length prices. Because of the demand for VAT-free fixed assets, businesses that sell fixed assets could be induced to sell at least part of their output in the informal economy. Finally, this system is highly inefficient as refunds are often delayed by the tax administration.

The government has attempted to address these issues. For imported heavy machinery used in basic industries, the VAT paid on imports can be claimed in the form of a CIT credit, which can be carried forward (although the tax credit is not indexed to compensate for the time deferral). More generally, the government has announced that businesses will start to be refunded for the VAT paid on fixed assets at a rate ranging from 0% (no refund) to 16% (full refund), with the actual refund rate set depending on whether the tax administration meets its tax revenue target. However, no actual refund rate has been published by the government so far, mainly because refunding VAT would cost a lot of revenue.

Colombia has different options to reform its VAT system. It could move towards a full consumption-based VAT system either immediately – by refunding VAT on fixed assets at the standard VAT rate of 16% – or gradually – by increasing the refund rate over time. As refunding VAT on fixed assets, whether immediately or gradually, would cost significant tax revenue, an option in the shorter run could be to make the existing system more efficient. This could be achieved by attributing "stars" to companies based on their previous tax compliance record. Companies which receive top ratings (e.g. 3-star rating) would be entitled to quicker VAT refunds. This would also reduce the need to audit every transaction and company as authorities could focus primarily on companies with poor tax compliance records.

Net Wealth Tax

Rate

Between 2011 and 2014, Colombia imposed a net wealth tax on both individual and business taxpayers whose wealth was equal to or exceeded COP 1 billion. The wealth tax charged taxpayers a lump sum based on their declared net wealth on January 1, 2011, with the amount payable over four years. The marginal tax rates varied from 1% for taxpayers with a taxable net wealth between COP 1 and 2 billion to 6% for taxpayers with wealth above COP 5 billion (Table 2), which amounts to 1.5% per year over the four-year period.

Table 2 **Wealth tax rate schedule**

Net worth	Rate	Surtax rate	Total
< COP 1 billion	0%	0%	0%
COP 1 billion – COP 2 billion	1.0%	0%	1.0%
COP 2 billion – COP 3 billion	1.4%	0%	1.4%
COP 3 billion – COP 5 billion	2.4%	0.6%	3.0%
> COP 5 billion	4.8%	1.2%	6.0%

The government has proposed to maintain the wealth tax until 2018 with the current top annual rate of 1.5% and to increase the CREE rate to 12%. A previous proposal was to keep the CREE rate at 9% but to raise additional revenues through the wealth tax by lowering the threshold at which the tax becomes payable to COP 750 million and by raising the top marginal rate to 2.25%.

Starting in 2015, instead of paying the wealth tax at a proportional rate on net wealth, a marginal and progressive rate schedule from 0.2% to 1.5% per annum would be applied. This change will reduce the effective tax rate for taxpayers in the lower tax brackets.

Taxable base

The taxable base under the wealth tax equals net equity (i.e. assets minus liabilities). The value of shares in domestic companies multiplied by the Net Present Value (NPV) rate can be deducted from the wealth tax base (where the NPV rate equals the ratio of net equity over gross equity). This means that if taxpayers do not have a lot of liabilities, the NPV rate will be high and a large percentage of shares will be deductible from the tax base. On the contrary, if taxpayers' shares in domestic companies are largely funded through debt, the NPV rate will be low and only a small part of the value of these shares will be deductible. The first COP 319 million of the value of taxpayers' primary house is also deductible.

Because the value of shares or company interests in Colombian companies and part of the primary house value can be deducted from the tax base, the Colombian wealth tax distorts individuals' savings and investment behaviours by encouraging some forms of savings over others.

The taxation of business wealth differs significantly from common practice in OECD countries. Out of the few OECD countries that levy a wealth tax, none of them except Luxembourg tax business wealth. The Colombian wealth tax on businesses is highly distortive as it comes on top of an already high combined CIT and CREE rate. The cascading effect of the total CIT/CREE/wealth tax can raise corporate effective tax rates up to 51% (Clavijo et al., 2013). One of the justifications for taxing business wealth is that individuals often keep their personal wealth within corporations.

The accounting system in Colombia also differs from international practice. As a result, deferred charges (i.e. assets which yield a return only in the future) are included in the assets. This system strongly deters investment from companies in the oil sector as their exploration expenditures need to be capitalised and become part of their equity.

Marginal Corporate Effective Tax Rates

The OECD calculated the cost of capital and the total marginal effective tax burden on businesses under different scenarios. Table 3 and Box 1 show the cost of capital and marginal corporate effective tax rates for situations in which the type of investment differs (either equity or debt-financed) and in which the taxes that are imposed on businesses vary (VAT on fixed assets, wealth tax, CIT and CREE). The results

reflect the varying effective burden of the different taxes on investment and highlight that the wealth tax and the VAT on fixed assets account for a significant part of the total effective tax burden on businesses.

Taking into account the 25% CIT rate, the 9% CREE rate, the 1.5% wealth tax as well as VAT on fixed assets, the OECD calculations find that if businesses wish to earn a 5% real after-tax return on their investment, they need to earn a pre-tax return (i.e. cost of capital) of 12.7%. This implies that the total marginal effective tax burden on businesses is currently in the order of 60% (Table 3).

It should be noted that the actual METRs faced by companies in Colombia are likely to be even higher than the results shown below as sub-central business taxes are not taken into account in the calculations. For instance, the local (municipal) tax known as the industry and trade tax, which applies to businesses in addition to national corporate taxes, is not included.

Table 3 **Costs of capital and marginal corporate effective tax rates in Colombia**

	Equity-financed investment		**Debt-financed investment**	
	Cost of capital (p)	Corporate METR (tc)	Cost of capital (p)	Corporate METR (tc)
25% CIT, 9% CREE, no VAT, no wealth tax	7.6%	34%	4.0%	-26%
25% CIT, 9% CREE, VAT, no wealth tax	10.4%	52%	7.0%	29%
25% CIT, 9% CREE, VAT, 1.5% wealth tax	12.7%	60%	7.0%	29%
25% CIT, 9% CREE, VAT, 2.25% wealth tax	14.2%	65%	7.0%	29%
25% CIT, 12% CREE, VAT, 1.5% wealth tax	13.2%	62%	7.0%	28%
0% CIT, 9% CREE, VAT, 1.5% wealth tax	9.6%	48%	7.3%	32%

Source: authors' calculations

Box 1. Marginal corporate effective tax rates and cost of capital in Colombia under different scenarios

Calculations of the cost of capital and marginal corporate effective tax rate allow assessing the burden imposed by the corporate income tax on investment. The cost of capital reflects the required pre-tax real rate of return on a marginal investment such that the investor after-tax breaks-even (i.e. for the investment project to be worthwhile at the margin). Based on this pre-tax real rate of return, the marginal corporate effective tax rate (METR) can be calculated. For instance, in a situation where a business wishing to earn a real after-tax return on its investment of 5% needs to earn a pre-tax return of 10%, the marginal corporate effective tax rate is 50%. The simple formula is: **tc= (p-r)/p** in which *tc* is the marginal corporate effective tax rate, *r* is the post-tax real rate of return and *p* is the cost of capital. The calculations assume that the real after-tax return on investment that the investor expects is 5% while the inflation rate is 2% (hence, the investor requires, when all taxes at the corporate level have been paid, to earn a nominal return of 7%). The calculations also assume that tax depreciation allowances follow the economic depreciation of assets, meaning that depreciation has a neutral impact on the calculations. The results show a widely varying effective burden of the different taxes on investment but also point to tax-induced distortions in investment decisions (see above Table 3).

Case 1 – 25% CIT, 9% CREE, no VAT, no wealth tax: In this situation, only the CIT and the CREE apply. As expected, the corporate METR for equity investments is 34% (25% CIT + 9% CREE). In the case of a debt-financed investment, the METR is -26%. This is because not only real but nominal interest payments are deductible from the CIT and the CREE bases.

Case 2 – 25% CIT, 9% CREE, VAT, no wealth tax: In this case, all taxes apply except the wealth tax. This case highlights the distortive impact of VAT levied on investment which raises the corporate METR from 34% to 52% in the case of an equity-financed investment and from -26% to 28.9% for a debt-financed investment. This result is explained by the fact that a business needs to earn a return on the *total* cost of investment which includes the unrecoverable VAT.

Case 3 – 25% CIT, 9% CREE, VAT, 1.5% wealth tax: This case describes the situation in which all taxes apply, including the 1.5% wealth tax. This means that a business that wants to earn a real after-tax return of 5% needs to earn a pre-tax return of 12.7%, which implies that the METR is around 60%. In the case of a debt-financed

investment, the introduction of the wealth tax does not affect the METR as the wealth tax only applies to net wealth (i.e. assets net of liabilities). The cost of capital increases with more than 1.5% because the wealth tax has to be paid from after-tax profits; as a result, the wealth tax increases with 1.5% divided by (1-34%).

Case 4 – 25% CIT, 9% CREE, VAT, 2.25% wealth tax: This case describes the situation in which the wealth tax were to be increased to 2.25% per year. It shows that to earn a real after-tax return of 5% on an equity-financed investment, a firm would have to earn a before-tax return of 14.2%. I.e. investors in Colombia face a tax-induced incentive not to undertake investment projects that yield a return below 14.2% as these projects are not profitable after tax (under the assumption that investors require an after-tax real rate of return of 5%). Investors which require a higher after-tax real rate of return will face even stronger tax-induced disincentives to invest. This implies that the METR amounts to about 65%. Again, in the case of a debt-financed investment, the increase in the wealth tax does not affect the METR.

Case 5 – 25% CIT, 12% CREE, VAT, 1.5% wealth tax: This case describes the situation in which the CREE rate is increased to 12% while the top wealth tax rate is kept at 1.5%. This reform increases the cost of capital of equity-financed investment to 13.2% and the METR to 62% which is lower than under a reform which increases the wealth tax rate to 2.25% (Case 4).

Case 6 – No CIT, 9% CREE, VAT, 1.5% wealth tax: This last case looks at the cost of capital and METR for a small business that decides to incorporate (which is not required to pay CIT in the first year following incorporation). The results show that although small businesses receive a tax incentive to incorporate, the real effect of the incentive is limited compared to the combined effect of the VAT on investment, the wealth tax and the CREE (METR of 48%).

General observations:

- In general, companies face very high METRs in the order of 60% in the case of equity-financed investments. The total effective tax burden is even higher than the METRs shown in the table because the model does not take into account sub-central taxes on businesses. METRs will further increase if the wealth tax rate is raised. Indeed, with a 2.25% wealth tax, the total corporate tax burden would reach about 65%. Increasing the wealth tax rate to 2.25% is more harmful for investment than increasing the CREE rate to 12%.

- Businesses have a significant incentive to finance investment through debt as interest payments are deductible from the CIT and the CREE and no wealth tax is effectively levied.

- Capital-intensive investments are highly discouraged as they are hit harder by VAT and the wealth tax than other types of investments. This effect was reinforced by the introduction of the CREE to replace payroll taxes which further increased the tax burden on capital-intensive businesses compared to labour-intensive firms.

- Small businesses receive a tax incentive to incorporate and become formal as they are not required to pay CIT in the first year of their incorporation and are then subject to a reduced CIT rate for four years. Effectively, however, the impact of this incentive is relatively limited as the total burden on small businesses of the VAT on investment, the wealth tax and the CREE remains very high.

As part of the 2012 tax reform, the tax administration introduced stricter transfer pricing rules, thin capitalisation rules and other general anti-avoidance tax provisions which make it harder for businesses to avoid the taxes levied at the corporate level in Colombia. The introduction of these stricter international tax rules is a step in the right direction and should now be followed with the introduction of a more efficient corporate tax system and a lower corporate effective tax rate in order to prevent businesses from facing a too high tax burden on investment.

As shown in Table 3, if the CREE rate was raised to 12%, the cost of capital would increase to 13.2% and the corporate METR to 62%. An increase in the wealth tax would also pose serious risks for the Colombian economy. The total marginal effective tax burden would increase to close to 65% on equity-financed investments if a 2.25% wealth tax was introduced, strongly reducing incentives to invest and

possibly leading to disinvestment by mobile types of companies. An increase in the wealth tax could also generate additional incentives to finance investment through debt and to engage into further corporate tax planning.

Financial Transaction Tax

The Colombian financial transaction tax was originally introduced at the rate of 0.2% as a temporary measure to respond to the economic crisis of 1998. It was later increased to 0.4% of the total transaction amount. It is charged on all financial transactions including banknotes, promissory notes and internet banking. In general, the financial transaction tax is withheld by the financial entities through which the operations are performed. Income taxpayers are allowed to deduct 50% of the tax from taxable income.

The tax was supposed to be phased out progressively at the rate of 0.2% in 2015, 0.1% in in 2016 and 2017, and 0% in 2018 and onwards. However, the government announced in October 2014 (see footnote 2) that it will maintain it until 2018. According to this new reform proposal, the financial transaction tax will be maintained at the same rate and only start to decline to 0.3% in 2019 with a view to fully removing it in 2022.

Similar financial transaction taxes are common in other Latin American countries and in Asia (Matheson, 2011). They are appealing because they are usually seen as a quick means of raising substantial revenue and are relatively easy to administer. However, there are a number of risks associated with such taxes. They tend to hamper financial deepening, which in turn adversely affects business sector growth and encourage cash operations, and usually results in greater informality and revenue losses from other taxes (OECD, 2013a). Revenues from these types of taxes also have a tendency to decline over time, as taxpayers find ways to circumvent them. Governments frequently end up raising the rate in an effort to address revenue erosion, which can lead to an even stronger contraction of the tax base (Matheson, 2011).

Moving forward, a first option would be to phase out the financial transaction tax altogether. An alternative would be to maintain a financial transaction tax but to levy it only on certain types of transactions. For instance, a tax on high-frequency trading could continue to raise revenue from the financial sector as well as lower the risks of asset price bubbles. However, like other transaction taxes, such a tax would have cascading effects, raising the cost of capital for some businesses more than others and possibly increasing financial disintermediation (Matheson, 2011).

Voluntary Disclosure Programme

The Colombian tax system suffers from high levels of offshore and domestic tax evasion, which have been encouraged by highly distortive taxes and instability from the armed conflict. Offshore evasion often takes the form of placing assets in neighbouring Panama or islands in the Caribbean while domestic evasion typically involves remaining in the informal economy or owning assets which are either under-valued (e.g. real estate, land) or not subject to governmental control (e.g. cattle).

The government is planning to make offshore tax evasion a criminal offence and to introduce a temporary voluntary disclosure programme between 2015 and 2017 to encourage the disclosure of undeclared assets held abroad by Colombians. During this period, criminal sanctions would be waived for taxpayers who come forward but penalties would apply on the value of their undeclared assets. The penalty rates would gradually increase from 10% of net wealth in 2015, to 15% in 2016 to 20% in 2017. Currently, taxpayers are only criminally liable when withheld taxes and VAT are not paid within the two months following the due date.

However, voluntary disclosure programmes need to be very carefully designed in order to be successful (see Box 2) and the programme planned by the Colombian government raises a number of

issues. First, the government is only planning at this stage to make offshore evasion a criminal offence, leaving domestic evasion unaddressed. This is a major gap as domestic tax evasion is widespread.

The Colombian voluntary disclosure programme may also not be credible and generate insufficient incentives for taxpayers to disclose their assets. The previous unsuccessful tax amnesties in Colombia (in 1995, 2003 and a failed attempt in 2012) could weaken the credibility of this new voluntary disclosure programme. The tax administration's relatively limited audit capacity may also make the disclosure programme less credible. If the disclosure programme is not perceived as a credible one-off offer, it could end up being counter-productive as honest taxpayers may resent it and stop paying their taxes or as evaders may prefer to wait for a future disclosure programme.

Finally, there might be technical difficulties associated with the implementation of the Colombian voluntary disclosure programme. According to the planned disclosure programme, both foreign bank accounts and immovable property will have to be declared. If taxpayers' assets amount to less than USD 50 000, detailed information will not be required. For assets greater than USD 50 000, detailed information will have to be provided for each asset. In the case of incorrect declarations, criminal sanctions will apply even if taxpayers have stepped forward. This implies that without clear valuation guidance from the Colombian tax administration taxpayers will likely prefer not to disclose their assets. In addition, Colombians will likely choose not to come forward if the voluntary disclosure programme does not stipulate that taxpayers who report their assets will remain anonymous and not be prosecuted retro-actively.

Box 2. OECD practices to encourage voluntary disclosure

All compliance strategies aim to strike a balance between encouraging and supporting voluntary compliance and countering non-compliance. Ideally, there should be enough of a perceived incentive for the target population to take part in the voluntary disclosure programme, without so much of a real incentive as to alienate the majority of taxpayers who are already compliant. Some countries have addressed this by collecting the full amount of tax due on previously undisclosed income, and offering incentives to disclose only through a temporary reduction in generally applicable levels of penalties and/ or interest. Similarly, arrangements for potential referral for criminal prosecution, or the number of years over which the revenue authority will look back, may be clarified, or temporarily alleviated, for the purpose of the voluntary disclosure programme.

OECD countries follow different approaches to encourage non-compliant taxpayers to come forward on a voluntary basis, but almost all countries have features in their general law (including their administrative practices) that in one form or another encourage voluntary disclosure. In addition, some OECD countries have recently implemented, or are currently implementing, special offshore voluntary disclosure programmes for a limited period of time (including Australia, France, Israel, Mexico, the Netherlands, Portugal, the United Kingdom and the United States).

Tax due: In the vast majority of OECD countries, the voluntary disclosure programme implies that the taxpayer must pay the amount of tax owned in the absence of a voluntary disclosure. This situation is different under special programmes in a certain number of countries where the tax is reduced and/ or computed differently (e.g. Greece, Italy, and Portugal).

Interest on the tax outstanding: In all OECD countries, taxpayers have to pay interest on tax evaded if their tax evasion is detected by the tax authorities and they have not made a timely and comprehensive voluntary disclosure. Interest charges are sometimes reduced in cases of voluntary disclosure, especially under special voluntary disclosure programmes but Canada, Hungary and Poland also foresee reduced interest charges in the case of a voluntary disclosure based on their general tax law.

Monetary penalties: In all OECD countries taxpayers face monetary penalties in cases of tax evasion if a timely and comprehensive voluntary disclosure has not been made. Many countries reduce the monetary

penalties to nil following a voluntary disclosure by the taxpayer. Even when penalties are not eliminated they are often substantially reduced in the case of a voluntary disclosure.

Imprisonment: In all OECD countries taxpayers risk imprisonment if their tax evasion is detected by the tax authorities without them having made a timely and comprehensive voluntary disclosure. However, in most countries the non-compliant taxpayer can avoid imprisonment through a voluntary disclosure, but not in Australia, Chile, Denmark, Finland, Iceland, Japan, Korea and Slovenia.

Other sanctions: Very few countries (e.g. Ireland and the United Kingdom) publish the name, address and occupation of a taxpayer but only if the taxpayer did not disclose on a voluntary basis and the evaded tax liability exceeds a certain threshold.

The Taxation of Dividends

Corporate level dividend withholding tax

Dividends paid to corporate and individual shareholders are exempt from further Colombian tax if dividends are distributed out of profits that have been taxed at the corporate level at the standard or at a reduced corporate tax rate. However, if profits that are distributed have effectively not been taxed at the corporate level, they are subject to a corporate level dividend withholding tax. This is the case of businesses earning tax-exempt income, such as the hotel sector, software developers and publishing companies. When those businesses distribute dividends out of their tax-exempt profits, they have to pay the withholding tax on those dividends. The withholding tax does not apply to businesses that benefit from a reduced CIT rate, such as companies in FTZs.

The amount of dividends that can be distributed without triggering further tax is calculated according to a set formula. Dividends up to taxable net income and capital gains (i.e. net of any deductions such as tax depreciation and investment allowances) *minus* income and capital gains tax paid (but not the CREE) *minus* tax credits for taxes paid abroad on dividends received (and taxed) by the tax resident corporation in Colombia *plus* tax-free types of dividends, can be distributed by the distributing corporation without having to pay the dividend withholding tax. The maximum amount of dividends that can be distributed without additional tax (calculated by the set formula) net of the actual amount of dividends that have been distributed can be carried forward for five years such that these “excess” dividends can be distributed net of additional tax over the next five year period. The excess amount of dividends can also be carried backward with respect to the two previous years. Distributed profits exceeding the calculated amount are taxed under the dividend withholding tax.

The dividend withholding tax is levied at a rate of 20% if untaxed dividends are paid to resident shareholders who file a tax return and/ or receive a small amount of dividends (less than 1 400 UVTs in the corresponding fiscal year), or 33% if the dividends are paid to foreign shareholders (except if a tax treaty has a lower withholding tax) or resident shareholders who do not have to file a tax return. In general, the Colombian tax treaties reduce the dividend withholding tax to 15%.

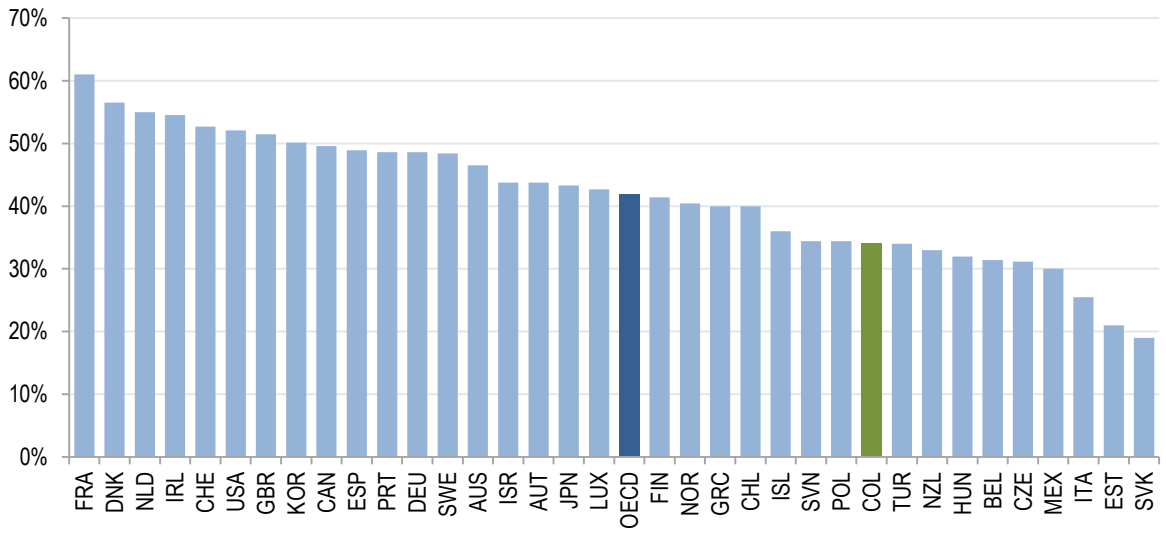
In the past, profits distributed by branches were not taxed under the dividend withholding tax. This allowed certain corporations to circumvent the tax; this loophole has recently been closed by the government. Despite the additional compliance and enforcement costs, the withholding tax ensures that exempt corporate income does not escape taxation at the corporate level. The rationale for taxing different types of dividends at different dividend withholding tax rates, however, is not clear.

Overall level of taxation on dividends

The taxation of personal capital income is low and partly accounts for the relatively small share of taxes paid by top-income households in Colombia. Figure 3 shows the combined top statutory rates on dividends, which take into account countries' statutory CIT rates as well as the top statutory tax rates on dividends at the shareholder level. In the OECD, while large differences exist across countries, the average combined top statutory tax rate on dividends exceeds 40%. Colombia's taxes on dividends are lower than the OECD average as dividends are only taxed at the combined statutory CIT and CREE rate of 33%-34% (Figure 3). Because capital income tends to be concentrated at the top of the income distribution, having relatively low taxes on personal capital income limits the progressivity of the tax system. Therefore, to increase the overall progressivity of the tax system but also to potentially use the revenue to lower the CIT rate, Colombia faces the option to introduce a dividend tax levied at the personal shareholder level in line with practice in most OECD countries.

Figure 3. **Combined top statutory tax rates on dividends**

(Corporate and personal shareholder levels)



Source: authors' calculations

The current approach of not taxing dividends at the personal level has advantages. The main advantage is that, in contrast to most OECD countries, there is no economic double taxation of profits (even if the level of the tax burden matters more than whether dividends are taxed once or twice).

However, there is a significant imbalance between the taxation of capital income at the personal and corporate levels in Colombia. On the one hand, the overall level of taxation on dividends and capital gains at the personal level is very low if only the CIT and CREE are considered. On the other hand, the tax burden on distributed dividends is very high when VAT on investments and the business wealth tax are also taken into account. The combined tax burden then exceeds 60% (for an investment earning a 7% nominal return, see Table 3). This suggests that if Colombia were to introduce a dividend tax at the shareholder level, the tax burden on capital at the corporate level would have to be significantly reduced to avoid having very high combined corporate and individual rates.

There might be risks associated with the introduction of a tax on dividends at the shareholder level. A tax on dividends could reduce incentives for investors to purchase new equity. It could also cause a

decrease in dividend pay-outs. Firms would also have an incentive to distribute dividends to companies abroad to escape taxation.

To shift and increase the taxation of capital income at the personal level, Colombia could consider different options. The first option could be the introduction of a tax levied on dividends distributed to Colombian personal shareholders but withheld at the corporate level, as was recently implemented in Mexico. Such a tax would have to be levied on dividends distributed to tax resident shareholders only (and not on foreign shareholders) to prevent that the tax would be seen as a pure withholding tax which would go against the withholding tax agreements in double tax treaties. A dividend tax withheld at the corporate level is easier to administer – there are less corporations distributing dividends than shareholders receiving dividends – and would be more difficult to evade (e.g. by Colombian tax residents whose dividends are paid to an offshore account). However, such a tax would not allow taxing dividends at progressive personal income tax rates.

Another option would be to establish a dual income tax system. Many OECD countries, including Denmark, Finland, Norway or Sweden, implement a dual income tax system in which labour income is taxed at progressive rates and capital income is taxed separately at proportional and typically lower rates. In most dual income tax systems, the rates are set such that the combined burden on capital income levied at the corporate and personal shareholder level is equal or close to the top tax rate on labour income to avoid arbitrage. Recently, several countries in Latin America have moved towards similar schemes (IADB, 2013). While a dual income tax might be slightly less progressive than an income tax system that taxes capital at progressive PIT rates, it has a number of characteristics that make it an attractive option for Colombia. Dual income tax systems are easier to administer than comprehensive schemes as they can be implemented with a withholding at source and can be levied on a broad capital income tax base. Furthermore, if rates are set coherently, there are fewer incentives for tax avoidance. This makes them often more progressive than integral schemes in countries with weak tax administrations and where the capital income tax base is narrow. Compared to the current situation, this would allow taxing capital income at the personal level at higher rates and therefore increase progressivity.

In the longer run, Colombia could consider introducing a full dividend imputation system similar to the systems which are in place in Australia, Chile, Mexico, New Zealand, Canada and Korea. Under an imputation system, dividends would be taxed under the PIT but shareholders would be granted a tax credit which offsets all or part of the corporate tax paid on the distributed profits. The corporate tax effectively functions as a prepayment against the tax on dividend income applied at the individual level. This would further increase progressivity as the progressive PIT rate schedule would apply and allow PIT to be collected if PIT rates are higher than CIT rates.

The Taxation of Pension Savings

Contributions to private pension funds are deductible from taxable personal income up to COP 104 million (about EUR 42 000) per year, with a maximum of 30% of total income. Moreover, pension funds are not taxed on their return on investment and the pension itself is largely tax-exempt in the hands of the pensioners; pension payments are only taxed on the amount exceeding COP 27 485 000 (about EUR 11 000) per month. The Colombian “exempt-exempt-exempt” (“EEE”) tax treatment benefits the rich as the value of the exemptions increases with marginal PIT rates.

By contrast, in OECD countries, pensions are typically taxed at least at one of the three stages. OECD countries either exempt a limited amount of private pension contributions from PIT or exempt the pension payments from PIT. The return on investment realised by the pension fund is often not taxed or taxed at a reduced rate. This highlights that private pension savings are very favourably taxed in Colombia compared to common practice in the OECD.

The 30% cap on the deductibility of private pension savings has been introduced as part of the 2012 tax reform. This restriction went hand in hand with a reduction in the tax-induced incentives to save through a special "housing savings account". There was a strong rationale for this dual limitation as mortgage interest payments are also tax deductible up to a certain limit in Colombia.

The introduction of a dividend tax in Colombia as suggested above would further increase the incentives to save tax free through a pension fund instead of investing directly in shares.

Colombia has various options to increase the taxation of pension savings including taxing high pensions in the pay-out phase, taxing pension funds moderately on their return on investment, or further limiting the deductibility of private pension savings from personal taxable income to raise more revenues from PIT.

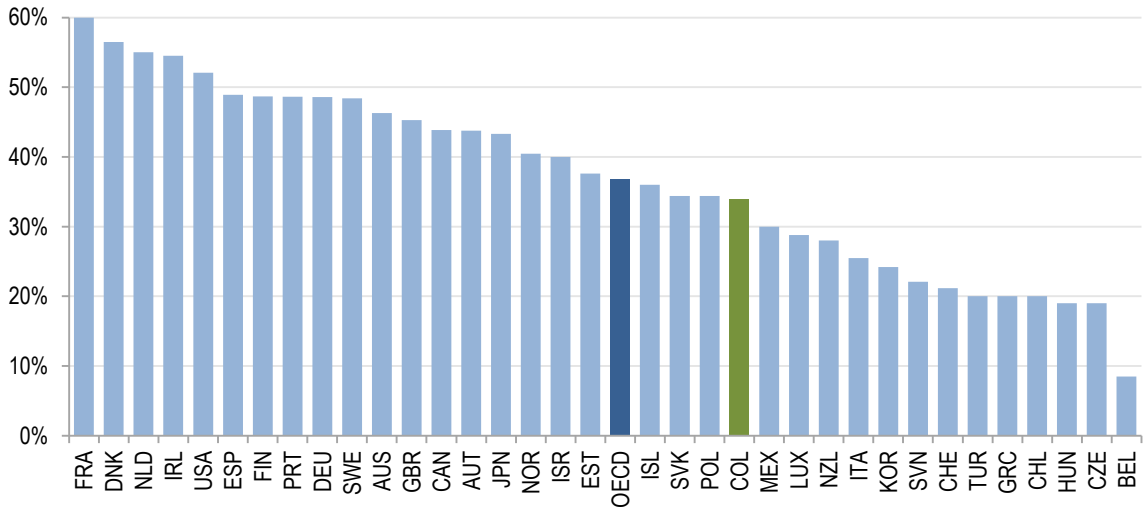
Capital Gains Tax

Capital gains are taxed on realisation. The 2012 reform reduced the capital gains tax rate for both Colombian and non-Colombian residents from 33% to 10% for capital assets held for at least two years. The gains from the sale or exchange of assets held for less than two years are subject to ordinary PIT rates.

The gains realised from the sale of certain assets are taxed at lower rates or are tax-exempt. For instance, the gains derived from the sale of shares through a stock exchange are exempt from the capital gains tax, provided the shares sold do not represent more than 10% of the total shares of the Colombian company. This explains why the combined statutory rate on capital gains from shares in Figure 4 is 34%. For owner-occupied property, there are limited exemptions, including the exemption of the first 7 500 UVT (EUR 82 500) of the profit from the sale of a house or flat owned by a taxpayer if the property is valued under 15 000 UVT (EUR 165 000).

Figure 4. **Combined top statutory tax rates on capital gains**

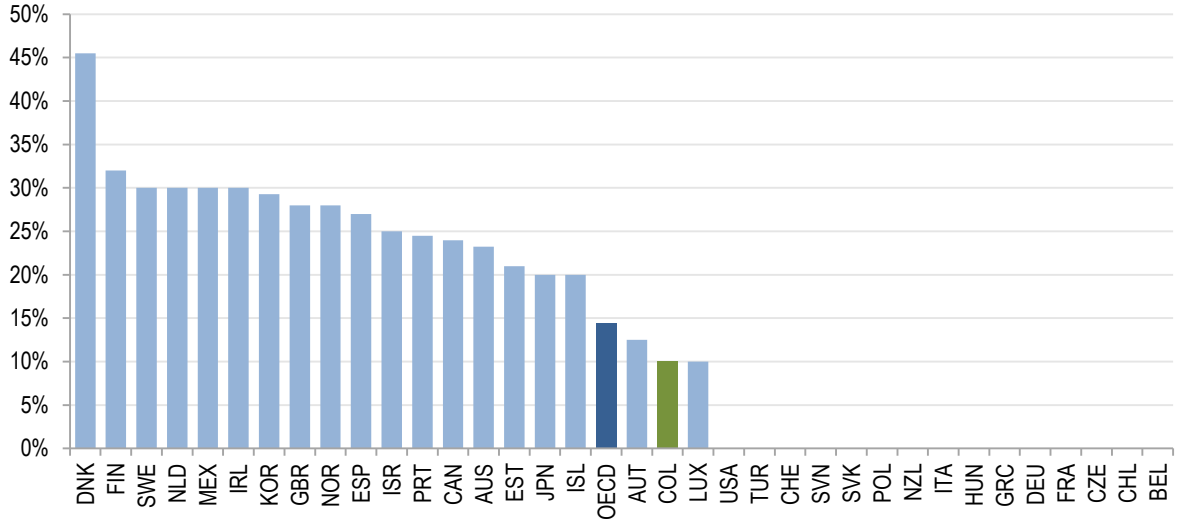
(shares)



Source: authors' calculations

Figure 5. **Combined top statutory tax rates on capital gains (property)**

(property)



Source: authors' calculations

As shown in Figures 4 and 5, the statutory tax rates on capital gains in Colombia are lower than OECD averages for both shares and immovable property. For shares, the combined statutory tax rates in the OECD range from 8% in Belgium to 60% in France, and the average is 37%. For property, the OECD average is 14%, with many countries not imposing any tax on capital gains from property and a top tax rate of 46% in Denmark.

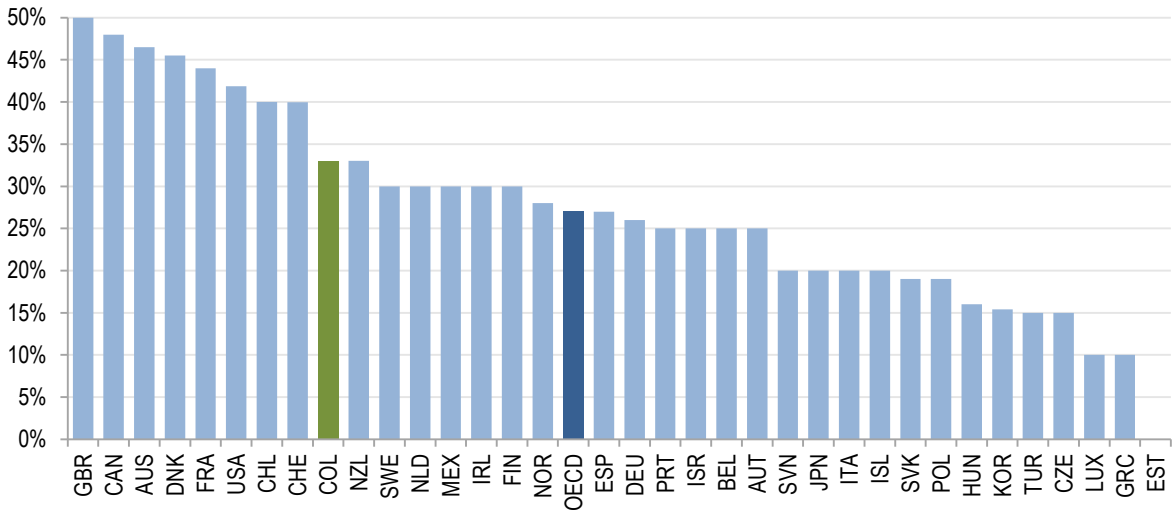
A shift in the capital income tax burden from the corporate to the personal shareholder level may have to be accompanied by an increase in the capital gains tax rate. Indeed, if dividends were to be taxed at higher effective tax rates than capital gains, corporations would no longer have an incentive to distribute profits but rather to retain and reinvest them. As a result, profits would be "locked-in", which would ultimately reduce the possibility for young and growing companies to attract external equity financing.

The Taxation of Interest Payments

There is no specific definition of interest but, for tax purposes, the concept generally includes all amounts paid by a debtor to a creditor in relation to the credit granted, even if the amounts are paid as if they were fees, commissions or similar payments. Interest income received by resident individuals is included in their taxable income and taxed under ordinary rules (i.e. rates ranging from 0% up to 33%). Withholding tax rates vary, generally between 7% and 4%. There is an adjustment for inflation.

Compared to OECD countries, the top statutory tax on interest payments in Colombia is relatively high. As shown in Figure 6, top statutory tax rates on interest income from retail deposit institutions in the OECD range from 50% in the United Kingdom to 0% in Estonia, with a simple average for all OECD countries of 27%. Colombia's financial transaction tax (see above) further increases the effective tax burden on interest income, suggesting that phasing out the financial transaction tax would help improve the situation.

Figure 6. **Top statutory tax rates on interest payments**



Source: authors' calculations

Continuing to tax interest payments under PIT progressive rates may be problematic if a dual income tax system is put in place as dividends would be taxed at a lower proportional rate (see above). There might be a rationale, however, for taxing interest payments at a higher rate since they are deductible from corporate taxable profits.

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