



# Tax Expenditures Report

by the tax experts commission



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# Executive Summary

Tax Expenditures Report



## EXECUTIVE SUMMARY

*“The COVID-19 pandemic has exposed the structural deficiencies Colombia’s tax system has long suffered from. The tax system fails to deliver the revenues required by the government to meet the legitimate needs of its citizens, largely because of the spread of tax expenditures that have undermined the country’s tax base. This array of tax expenditures has further complicated an already complex tax system, discouraging entrepreneurship and investment, facilitating tax avoidance and evasion, and slowing the country’s economic development. The current tax system also fails to address inequalities in the distribution of income and wealth.”*

*“Colombia’s traditional approach of introducing piecemeal reforms will not raise sufficient revenue to finance the government’s budget deficit. Fundamental reform is required and the current crisis should be used to improve the design of the tax system. Not only would this help raise revenues in the short term, it could also enable Colombia to move towards a tax system that is more simple, efficient and equitable. One that can finance greater investment in infrastructure, education and healthcare to help generate prosperity for all Colombians.”*

*“But reform is not only a question of designing new tax rules; it requires a major shift in the way Colombian politicians and legislators think about, formulate and implement tax policy. Colombia has developed a habit of excessively using tax expenditures in an attempt to overcome structural economic and social issues that require reforms beyond the capabilities of the tax system. This approach needs to stop.”*

*“Our report sets out broad principles to guide the government as it moves towards fundamental reform of the tax system and provides recommendations on which tax expenditures should be removed as part of this process.”*

(Tax Incentives Commission, 2021)

### Colombia’s tax system is dysfunctional

Decades of misuse have left Colombia with a tax system that does not meet international standards of efficiency, equity and simplicity. An optimal tax system minimises distortions and interferences to economic growth (efficiency), limits the negative distributional implications of market outcomes, creates equal opportunities for all individuals and businesses to participate (equity) and minimises complexity to reduce tax-planning opportunities and ease compliance, administration and enforcement costs (simplicity). At present, Colombia’s tax system falls short in each respect.

Colombia’s dysfunctional tax system is largely the result of poor policy-making processes. Successive governments and legislators have used the tax system in an attempt to address Colombia’s structural economic deficiencies and have largely failed; these deficiencies cannot be resolved by the tax system alone and would be better tackled at source. It often appears that the tax reforms have been introduced without a comprehensive understanding of their economic impact, and particularly their long-term costs.

Piecemeal reforms have regularly been introduced in attempts to counteract the system’s imbalances. These have often been in the form of tax expenditures (provisions in the tax legislation that modify the tax liability of specific groups of individuals or businesses), many of which are rarely seen in OECD countries because of their distortive nature. For example, instead of allowing businesses to credit the input value-added tax (VAT) levied on investment in fixed assets against the VAT levied on its sales, a credit is provided

through the corporate income tax. But this only compensates businesses that are profitable and have a sufficiently high corporate tax liability, increasing the cost of investment in Colombia.

By progressively adding one tax expenditure on top of another, the Colombian tax system has become unnecessarily complex. Tax complexity imposes a number of costs for both taxpayers and the tax administration. Businesses and individuals have to devote more resources to comply with complicated tax rules – many have reoriented their activities to benefit from tax advantages or have chosen not to declare the full extent of their income and profits. The tax administration then has to spend more resources in enforcing compliance. High rates of informality persist and tax evasion often goes undetected.

Colombia's narrow tax base limits the capacity of its tax system to raise revenues. Highly conservative estimates suggest that Colombia forgoes tax revenues worth at least 6.5% of GDP each year, largely because of tax expenditures in the value added tax (VAT), and corporate and personal income taxes. This is excessively high. As a result, Colombia's tax-to-GDP ratio (19.4%) is notably smaller than its OECD (34.3%) and Latin American peers (23.1%). Colombia's tax revenues are insufficient to finance the necessary investments in infrastructure, education, healthcare, and other productivity-enhancing forms of government spending.

To compensate for the country's narrow tax base, high tax rates are imposed upon those who cannot avoid paying tax in Colombia. The top personal income tax rates on salaried workers are high and businesses face the joint-highest rate of corporate tax rates amongst OECD countries as well as a number of highly distortive business taxes such as the financial transaction tax and the municipal turnover tax. If all profit and non-profit based taxes that businesses have to pay are combined, the effective tax rate they pay on their total revenue rises to over one-and-a-half times the corporate tax rate. These high tax rates are but one factor that discourages domestic and foreign investment into Colombia.

Often tax expenditures that were added to recompense some individuals and businesses for these high tax rates reinforce inequalities. For example, regressive tax exemptions in personal income tax often leave richer Colombians paying less in tax than their poorer compatriots, while the tax holiday recently afforded to the tourism industry has heightened inequality across sectors of the economy. The tax and transfer system does not reduce Colombia's high levels of inequality, which is detrimental to economic growth.

Colombia must break this undesirable spiral of continuously introducing poorly analysed tax expenditures.

### The COVID-19 pandemic should push Colombia to fundamentally reform its tax system

The COVID-19 pandemic increased Colombia's budget deficit for 2020 to 9% of GDP. This gap is far too large to be resolved by just removing a few tax expenditures or introducing further distortive taxes. Fundamental tax reform will be necessary to raise sufficient revenues to reduce the deficit, but the crisis also offers the opportunity for Colombia to move towards a tax system that is more simple, efficient and equitable. One that can sustain greater investment in education, infrastructure and healthcare to help generate prosperity for all Colombians.

The Tax Incentives Commission therefore encourages Colombia to commit to a staged structural reform process that will steer the country towards a more optimal tax system, with lower nominal tax rates and a broader tax base. This report has been written in a way that can help start the reform process. First, it describes the direction tax reforms should lead in the long term as some changes will require more planning and for the economy to have fully recovered. Second, it identifies immediate improvements to Colombia's value-added, corporate and personal income taxes that can boost public finances and the effectiveness of the tax system in the short term. A balance must be found between implementing reforms too quickly and damaging the post-COVID recovery, or too slowly and scaring investors and credit rating agencies with widening budget deficits. Third, it suggests changes to the process of tax policy making so

that future reforms are fair, sustainable and support economic growth. The reforms should also consider how greater international cooperation could help with the more effective taxation of multinational companies and capital held offshore.

Fundamental tax reform is not just a question of designing new tax rules. It also requires a major shift in the mind-set of policymakers and legislators, who must resist the temptation to introduce new tax expenditures rather than working towards genuine tax reform.

## Improving the tax policy making process will support sustainable change

The Commission recommends three ways Colombia can improve its tax policymaking process:

First, create an independent group of tax and public finance experts to assist the Ministry of Finance in developing a strategy for implementing the reforms suggested in this report, and provide advice on the future of Colombia's tax system and related topics. Foremost amongst its considerations should be the context, sequence and timing of the reforms – the policy recommendations of this report are numerous and ambitious, and will need to be implemented over a number of years. Over time, the group's mandate could be extended to include the tax *and* transfer system, in accordance with international best practice.

Second, it should be mandatory for each new tax law proposal to include a framework chapter that provides a rationale for the reform and a detailed ex-ante impact assessment. This assessment should include the policy's implications for the simplicity, efficiency, equity and revenue raising capacity of the tax and transfer system, and be completed by the Ministry of Finance and DIAN. The aforementioned independent group of tax and public finance experts should then review and validate the assessments. The framework chapter could build upon Section 7 of Law 819 of 2003 to ensure there is an evidence base for reforms and thus limit the creativity of legislators to introduce tax expenditures.

Third, the economic analysis unit within DIAN should be given a stronger mandate and greater resources. These changes should help the unit to produce a standalone annual tax expenditure report, which lists all the tax expenditures in operation in Colombia's tax system and identifies their costs and distributional implications. DIAN has made notable improvements to their tax expenditures estimations during the Commission's work and should continue this process.



# Key Findings And Recommendations For Tax Expenditure Reform In Colombia

Tax Expenditures Report



# KEY FINDINGS AND RECOMMENDATIONS

## FOR TAX EXPENDITURE REFORM IN

## COLOMBIA

This chapter summarises the main findings of the “Tax Incentives Commission” (TIC) that was set-up by the Colombian government in August 2020 with a mandate to review the Tax Incentives, and more broadly the Tax Expenditures (TEs), within the Colombian tax system. In doing so, it provides a brief overview of the analysis carried out by the TIC in collaboration with the Colombian tax administration (DIAN), the Ministry of Finance (MOF), the OECD Centre for Tax Policy and Administration, and national and international tax experts who participated in the Working Party meetings.

The Report starts with a tax chapter that sets the scene and a chapter on TE reporting and measurement. The following chapters then present the in-depth analysis that the Commission has carried out through its five Working Parties. Each of the five Working Parties has identified and listed all the major TEs that apply to the respective tax or tax policy topic that was assigned to the Working Party:

- [Working Party 1: VAT](#)
- [Working Party 2: CIT, non-profit based business taxes and SIMPLE](#)
- [Working Party 3: Non-taxable/ exempt income/ gains, and tax benefits for the countryside](#)
- [Working Party 4: PIT, pensions and personal capital income](#)
- [Working Party 5: Free Trade Zones and International Logistics Distribution Centres.](#)

The Working Parties have assigned the main TEs in their respective area to four broad reform categories: 1) TEs that do not need reform; 2) TEs that can be reformed in the short run; 3) TEs whose reform is conditional upon other reforms; and 4) TEs for which it remains unclear whether they should be reformed.

### Tax Expenditures: an introduction

Tax Expenditures are provisions in the tax legislation that modify the tax liability of specific groups of individuals or businesses. Tax incentives are a sub-group of TEs that aim at incentivising certain types of behaviour, such as investment, savings, and employment. Governments around the world use TEs to achieve a wide range of policy objectives. These TEs may take the form of tax exemptions, allowances, credits, reduced rates or tax deferrals.

When properly designed, TEs can stimulate economic growth and improve well-being. However, TEs often come at a significant tax revenue cost, and thus an assessment of the relative costs and benefits of these tax provisions is required. In principle, TEs are justifiable if their social benefits exceed the associated social costs and there is not a better mechanism to deliver those benefits. In the case of investment TEs, such as tax holidays, the social benefits would typically involve net increases in investment, employment and wages, as well as productivity spillovers. Social costs would likely include net public revenue losses, administrative and compliance costs as well as distorted resource allocation and horizontal and vertical equity concerns.

TEs may also raise distributional concerns. Some TEs explicitly aim to improve the distributional effect of taxation, such as Value-Added Tax (VAT) exemptions for necessities, while other TEs may unintentionally have important distributional implications. In fact, richer households tend to benefit more from TEs than poorer households do. This is partly because tax reliefs are frequently granted in the form of allowances, the value of which increase with the taxpayer's marginal tax rate, but also because lower-income households may not have sufficient taxable income to benefit from certain tax provisions and are unable to take advantage of the tax-planning opportunities TEs can present.

As should be the case with other forms of public spending, cost-benefit analyses of TEs should help determine whether they are desirable policy instruments. In particular, the significant social costs of TEs make it essential to estimate the revenue foregone that each TE item represents on a regular basis. In most OECD countries, an item-by-item costing of TEs is reported annually to the public, and is integrated within the annual budget process. By displaying fiscal transparency, TE reports demonstrate government accountability and support evidence-based decision making on the allocation of public resources.

A key issue for any TE analysis is to determine the reference point, or “benchmark” tax system, relative to which the nature and extent of any tax concession can be established. Once a benchmark tax system is defined, TEs can be identified in a relatively straightforward manner, namely as those tax provisions that deviate from the benchmark. At present, Colombia has not defined a benchmark tax system. As discussed below, this does not constitute good practice.

## Colombia needs to steer away from the excessive use of TEs

In Colombia, the correct balance of TE use has been lost – the country employs far too many TEs, whose costs appear to far outweigh their benefits. The TIC believes that there has been, and continues to be, a systemic over-use of TEs to correct for structural deficiencies in the tax system. This has come at a significant cost to the Colombian people: undermining tax revenue collection, increasing horizontal and vertical inequities, reducing efficiency and adding unnecessary complexity.

A significant number of TEs in Colombia violate the “horizontal equity” tax design principle, according to which, “equals” should be taxed “equally”. For example, some TEs only provide a preferential tax treatment to particular businesses, such as the lower corporate income tax (CIT) rates for hotels, or the temporary tax holidays for profits linked to particular types of investments. Other TEs provide preferential tax treatment to certain individuals. For example, a percentage of the earnings of individuals working in specified careers, such as Judges and Prosecutors are tax-exempt, as are the representation expenses received by Deans and Professors of public universities. Not only do these TEs distort the design of the tax system and generate inequities, they also create the public perception, whether warranted or false, that political clientelism is at play. To compensate for forgone tax revenues from preferential treatments, the government must place higher tax rates upon other businesses and individuals or lower its provision of public goods and services.

Many TEs in the Colombian tax system also violate the “vertical equity” tax design principle, according to which taxpayers that have a larger capacity to pay should pay more tax. The most egregious example being the Personal Income Tax (PIT) allowances that are increasing with income. These TEs are extremely regressive as those with higher incomes not only enjoy a larger deduction, but the value of that deduction also increases with the taxpayer's marginal tax rate, which in itself increases with income because of the progressivity of the PIT rate schedule. Another example is the tax exemption of pensions (up to a very high ceiling), while the mandatory and voluntary pension savings are deductible from taxable personal income at the taxpayer's marginal PIT rate; the government is effectively subsidising pensions and that subsidy is higher for richer individuals.

In a number of cases, TEs have been introduced to correct for distortive, structural design flaws in Colombia's tax system. For example, the use of reduced CIT rates for specific sectors helps compensate a

selection of businesses for Colombia's high CIT rate (at 32%, it is the second highest in the OECD) and non-profit based business taxes. However, compensatory TEs often become distortive over time and narrow the tax base. In response to the narrowing CIT base – a result of the wide range of non-taxable and exempt income items, and non-standard deductions within the CIT – the government introduced a dividend withholding tax. This dividend withholding tax can be viewed as a form of recapture tax whereby firms who distribute dividends that have not been taxed under the CIT, are first subject to a dividend withholding tax levied at a rate equal to the CIT rate that applies to that type of business. The CIT recapture tax seeks to protect the size of the tax base, but because of the dividend withholding tax firms prefer not to distribute dividends and use their profits in alternative ways. The CIT recapture tax therefore becomes distortive in itself and raises little revenue (see also below).

There are also examples of TEs being introduced in one part of the tax structure to correct for distortions created by another part of the tax structure. For instance, the CIT credit for unrecoverable VAT on investment in fixed assets aims to correct for businesses' inability to credit the input VAT paid on investment in fixed assets against the VAT levied on sales. Other examples include the CIT credit for the local business turnover tax ICA and the CIT deduction for part of the debit tax.

The excessive use of TEs also creates distortions across different taxes. For example, while interest payments benefit from an inflation offset and therefore only the real rather than the nominal return is taxed, that approach is not followed for the return on equity. This creates a tax-induced bias against equity and in favour of debt.

Inconsistencies across different taxes can also occasionally result from the excessive use of TEs. For instance, when distributing dividends, corporations have to withhold a dividend tax at a rate of 7.5% when the dividends are distributed to another corporation. However, if the corporation receiving the dividends distributes these to an individual shareholder, up to a value of 300 UVT (around USD 2 900 or COP 11 million), no dividend withholding tax has to be paid. But neither the firm nor its shareholders receive a refund for the excess dividend withholding tax that has been paid by the first distributing company. One solution to solve this inconsistency is the introduction of yet another TE; complexity breeds complexity.

Non-tax experts might call for the immediate abolishing of all of Colombia's TEs, but this policy would be ill advised. Many of the current preferential tax treatments are necessary design features that seek to correct, albeit indirectly, for the tax distortions generated by the tax system's structural design flaws.

The importance of sequencing reforms should therefore not be underestimated. This report attempts to maintain this message throughout, by providing recommendations for reforms that can be made immediately and identifying those that require underlying structural deficiencies to be resolved before TEs are removed or refined.

## TEs distort the balance of Colombia's "tax mix"

The aim of any tax system should be to support sustainable improvements in citizens' well-being. The combination of taxes that a country chooses should therefore be aligned with their inclusive and sustainable growth agendas by using a mix of taxes that support progressivity and limit constraints to economic growth. In Colombia, however, the wide range of TEs present throughout the country's tax structure distort the tax mix between direct and indirect taxes. This has a significant impact on the tax revenue raising potential of a wide range of taxes and, eventually, will have a negative influence on inclusive economic growth.

Narrow tax bases and preferential tax rate treatment for the fortunate few induce government to increase standard tax rates in order to meet its revenue target. However, high rates are by themselves distortive, as the dead weight loss created by a tax increases with the tax rate. This is the well-known Harberger result. In general, governments should aim at keeping their tax bases as broad and the tax rates as low as possible.

Taking the example of the PIT, we can see how these TEs distort its intended function, and thereby distort the optimal tax mix in Colombia. The PIT is amongst the main taxes that can be levied at progressive rates. However, the TEs within the PIT strongly reduce the tax revenue raising potential of the PIT and limit its efficiency and equity. The way many of the PIT TEs are designed means they are highly regressive as they are increasing with income. This results in individuals paying exceptionally low effective tax rates on their personal income, despite the high and progressive tax rates imposed on labour income. As a result, most entrepreneurs prefer to form businesses that are unincorporated as the effective tax burden on personal business income is far below the tax burden on capital income. However, the low revenues raised by the PIT implies that other tax rates have to be raised, such as the standard CIT and VAT rate.

A narrow base can also be found within the VAT due to the large number of exclusions and exemptions. The weaknesses in the design of the VAT also have implications for the tax burden on goods that are harmful for health and the environment and, therefore for the design of health and environmental taxes, as VAT is levied on prices inclusive of excise duties. A (too) low VAT burden on goods that come with a negative external effect could be compensated through higher excise duties.

Some forms of taxation with only limited distortive effects are also under-utilised. Recurrent taxes on residential immovable property have been shown to be amongst the taxes that are the least distortive for economic growth, but have only a marginal role in Colombia's tax mix. In OECD countries, it is commonplace for immovable property taxes to be used to finance local governments; in 2018, these taxes raised the equivalent of 1.9% of GDP on average across the OECD. Instead, in Colombia local governments levy a local business turnover tax, which is highly distortive (see below) and raises very limited revenues. As of the taxable year 2022, Colombian taxpayers will be able to discount the total ICA paid during the period against their Income Tax, but this is yet another example of a TE being introduced that does not address the problem at its source.

### Incremental tax reforms within each tax will be ineffective because of the wide range of TEs

The wide range of TEs gives taxpayers a wide set of options to minimise their tax liabilities. For example, within the PIT, households can earn "exempt" income and benefit from tax relief for mortgage interest, savings via private savings accounts, private pension savings and private health insurance. Most of the TEs come with a cap – recent tax reforms have lowered the amount that can be claimed, but the ceilings remain very high in most cases. These types of tax relief come on top of a general tax reduction of 25% of labour income, the deduction of compulsory social contributions and a generous basic tax allowance. As a result, effective PIT rates are very low when expressed as a percentage of gross earnings. Abolishing a single PIT TE is not expected to have a large impact on the effective tax rates (ETRs) that individuals pay; individuals would likely just shift from one TE to another in the case that they had not already utilised all the TE opportunities that were available to them.

Similar examples can be observed within the CIT, where hotels and Free Trade Zone (FTZ) companies benefit from a reduced CIT rate of 9% and 20%, respectively, instead of the standard CIT rate of 32% in 2020. However, the tax revenue foregone estimates provided by DIAN show that the revenue cost of these TEs is relatively small. This might indicate that hotels and FTZ companies are not very profitable, and that the reduction in the CIT rate does not come at a large tax revenue cost, as hotels and FTZ businesses do not pay much CIT. However, it might also indicate that many hotels and FTZ businesses have a wide range of TEs available that they use to reduce their taxable income, so that they do not pay much CIT anyway, irrespective of whether the standard or reduced CIT rate is applied.

These observations have two major implications. First, when tax bases are very narrow, the tax revenue foregone estimates of individual TEs might be relatively small. The revenue foregone of a TE is estimated by comparing current tax liabilities (when the TE is available) with the tax liabilities that businesses or individuals would have paid in the absence of that specific TE. However, if taxpayers can choose between

many TEs to minimise their tax liability, they may have opted to use a mix of TEs rather than preferring one TE over the other TEs that are available. Moreover, the tax revenue foregone estimates do not typically consider behavioural changes. The actual revenue gain when a specific TE is abolished might be significantly lower when taxpayers face the option to shift to a different TE, which has not been abolished, to minimise their tax liabilities. The second implication is that when a wide range of TEs are available and individuals and businesses face different choices on how to minimise their tax liability, introducing an incremental tax reform that abolishes a few TEs but leaves the majority of the TEs in place will not result in a large increase in tax revenues. In this setting, raising tax revenues would require a more fundamental reform that broadens the base significantly.

Another disadvantage of incremental reform within each major tax, e.g. the CIT or PIT, is that it limits the ability of the government to resist pressures from specific lobbying groups, who may wish to maintain the TEs their stakeholders benefit from. A clear approach that eliminates a broad range of TEs, and at the same time opens up opportunities to reduce nominal tax rates, is more likely to gain the broad political support required for the implementation of reforms.

## The COVID-19 pandemic should push Colombia to fundamentally reform its tax system

The COVID-19 pandemic has left the Colombian government with a large budget deficit. It is therefore considering introducing tax reforms in the first half of 2021 to raise significant additional tax revenues. Raising sufficient finance will require a fundamental tax reform that follows leading practice design principles and standards, not a continuation of the piecemeal changes introduced over the last decades. A balance must be found between implementing reforms too quickly and damaging the post-COVID recovery, or too slowly and scaring investors and credit rating agencies with widening budget deficits.

Colombia should seek to move towards a system that embodies the international standards of equity, efficiency, and simplicity. An efficient tax system minimises distortions and interferences in the economy; an equitable tax system aims to operate as fairly as possible; and a tax system that is not overly complex leads to better administration, more transparency and improved compliance. Simplicity is important because it allows taxpayers to understand what the tax system expects of them, it reduces opportunities for tax avoidance and tax evasion, and it provides tax certainty. It also enables administrators to apply the tax rules in accordance with the spirit in which they were written and simplifies tax enforcement. At present, Colombia's tax system falls short against all of these characteristics.

The reforms should principally seek to broaden the tax base and, ideally, lower tax rates. They should also aim to strengthen the progressivity of the tax system, to ensure that Colombia's horizontal and vertical equity principles are satisfied, reduce economic and tax-induced distortions, and provide a tax mix that accounts for the socioeconomic challenges Colombia faces. For example, a system that can encourage formalisation and reduce inequality.

Tax complexity must also be reduced. Not only will this lower enforcement and compliance costs, it will also strengthen tax certainty for domestic and foreign investors. The reform must also be feasible for DIAN to implement, and allows DIAN the tax authority to collect sufficient additional tax revenues in the short run, i.e., if not in 2021, then from 2022 onwards.

Given these guiding principles and the constraints Colombia faces, the TIC believes that a successful tax reform requires changes to the structure of the PIT, a broadening of the VAT base and increases in taxes on goods that are harmful to citizens' health (e.g., tobacco, alcohol, sugar) and the environment (e.g. fossil fuels). These suggestions do not imply that the country should not reform the other taxes, in particular the CIT and non-profit based taxes that business have to pay, such as the municipal business turnover tax and the financial transactions tax. However, a fundamental reform of the business tax regime in Colombia is complex and touches upon many different areas. Reform of Colombia's CIT will require more planning,

preparation and consultation of different stakeholders, and some members of the TIC therefore hold the view that this would be better introduced in a second phase of the reform.

## Strengthening the annual TE report will help improve Colombia's tax policy

The TIC supports DIAN's efforts to improve the accuracy of its revenue forgone estimates and to develop an annual TE report. Each year the Ministry of Finance publishes a report that contains information on the country's macroeconomic outlook and fiscal strategy as well as information on the tax revenue foregone of a selection of TEs in the report's last chapter (Appendix, and Annex of the Appendix in the 2020 report). In addition to the *Marco Fiscal de Mediano Plazo*, DIAN publishes an annual working paper that describes CIT TEs in more detail. The TIC commends this work, especially as it is carried out with limited resources, and endorses DIAN's plan to develop its TE estimation and evaluation unit so that it can build a stand-alone, comprehensive, annual TE report with high quality TE revenue foregone estimates.

However, there is significant work to be done before Colombia can publish an annual TE report. First, Colombia does not define a tax benchmark, which is used to identify TEs. This major shortcoming needs to be addressed as a policy priority. The lack of a well-defined tax benchmark implies that some TEs remain unidentified and are therefore not listed in the TE report, while other tax concessions would not be considered as TEs under standard benchmarks. Ideally, the Colombian TE report should include a description of the TE tax benchmark, as well as a full list of all TEs in the tax system, with a reference to the legal code where the TEs are provided.

Enhancing the quality of the TE report requires changes to the methodology DIAN uses to calculate revenue foregone. The revenue foregone of all TEs has to be calculated and reported on an item-by-item basis, using the individual and business tax return data (for the PIT and the CIT) and national accounts' input-output data (for the VAT). However, this approach may require Colombia to make changes to its tax returns. Currently, taxpayers have the possibility to report an aggregated amount of certain types of tax provisions rather than reporting the TEs on an item-by-item basis, making it impossible for DIAN to report the tax revenue foregone of the individual TEs. The methodology used should be specified in the TE report to ensure full transparency.

The OECD have worked together with DIAN to help revise some of the tax revenue foregone estimations for Colombia's TEs. The assessment has identified that previous estimates of revenue foregone significantly overestimated the value of TEs within the VAT, while CIT and PIT TEs are likely to be underestimated as certain forms of non-taxable income and reduced rates from sector-specific tax regimes are currently not measured. There is therefore significant scope to improve these estimates, particularly for the CIT and PIT. Estimating and publishing the revenue foregone of the numerous special tax provisions classified as TEs by the TIC on an item-by-item basis, should be a priority.

A future TE report should also seek to provide more information than the revenue foregone of individual TEs. First, it should also include a sectorial analysis that lists and reviews all the TEs that particular sectors benefit from as while the tax revenue foregone of one single TE may be low, the overall impact of all TEs targeting a particular sector may be large. Sectoral analyses would improve transparency and help stimulate policy discussions on whether different sectors of the economy are equally treated by the tax system. Second, the TE report should include analyses of the distributional impact of TEs. This should be focused not only on salaries, personal business income and personal capital income, but also on pensions, which currently enjoy a particularly generous tax treatment, and from which high-income households benefit the most.

Publishing a separate annual TE report that covers the most important taxes (VAT, CIT and PIT) will increase the transparency of the costs of TEs. Greater transparency over TE costs will help make politicians and legislators more accountable for their tax policy decisions by informing democratic debate and voter

preferences. Concurrently, a comprehensive, annual TE report will help improve the policy-making process by providing information to politicians and legislators on the potential revenue implications of removing certain TEs. DIAN has made notable improvements to their TE estimations and the TIC welcomes DIAN's plans to continue this process.

## Improving the tax policy making process will support sustainable change

Colombia can strengthen its tax policy-making process through a range of measures. First, it should create an independent group of tax and public finance experts with a strong mandate to assist the Ministry of Finance in developing a strategy for implementing the reforms suggested in this report and provide advice on the future of Colombia's tax system and related topics. Over time, the group's mandate could be expanded to the tax *and transfer* system in accordance with international best practice.

Second, it should be mandatory for each new tax law proposal to include a framework chapter that provides a rationale for the reform and a detailed ex-ante economic assessment. DIAN and the Ministry of Finance should complete these assessments, which are then verified by the aforementioned independent group of tax and public finance experts. The economic assessment should include the policy's implications for the simplicity, efficiency, equity and revenue raising capacity of the tax and transfer system. The framework chapter could build upon Section 7 of Law 819 of 2003 to ensure that reforms are evidence-based and thus limit the creativity of legislators to introduce tax expenditures.

Third, the economic analysis unit within DIAN should be given a stronger mandate and greater resources. These changes should help the unit to produce a standalone annual TE report.

## Enhance the role of the PIT

The effective tax rates that individuals pay on their labour income, personal business income and capital income in Colombia are very low. These low ETRs are the result of numerous factors, including very generous tax deductions that increase with income, an array of tax exemptions, wide brackets within the PIT rate schedule and a generous basic PIT allowance, low rates on dividends and capital gains, and the partial tax-exemption of pensions. In addition, employers are also allowed to make tax-free contributions for pension savings, health insurance and educational expenses for their employees.

Colombia must reform the tax allowances within its PIT that increase with income. This form of tax design is egregiously regressive. First, the tax deductions that increase with size, so richer households obtain a larger tax deduction. Second, the value of a tax allowance increases with the taxpayer's marginal tax rate, so the value is higher for richer households. And third, lower income households typically do not benefit from deductions such as mortgage interest relief or voluntary pension contributions as their income is too low to own a house or to save extra for a private pension. These tax allowances, some of which are explained below, are hence very uncommon in the OECD as they create a significantly larger tax advantage for richer households.

Colombia should aim at both reducing the basic PIT allowance (currently 1 090 UVT, i.e. around USD 10 500 or COP 39 million) and abolishing the 25% labour income deduction (the 25% deduction has an economic ceiling of 240 UVT monthly (around USD 2 300 or COP 9 million monthly), i.e. 2 880 UVT yearly). In the short term, however, a more gradual reform could maintain the 25% income deduction and its monthly ceiling. This approach could help foster political support to significantly broaden the PIT base.

Colombia has a maximum value of TEs that can be claimed, equal to 40% of net taxable income and up to a maximum value of 5 040 UVTs (approximately USD 49 000 or COP 179 million). This TE ceiling serves as a base protection measure as the possibilities to reduce taxable income are large. The 40% of net taxable income ceiling is increasing with income and the value is increasing with the taxpayer's marginal PIT rate.



The ceiling itself is therefore excessively regressive (but mitigated through the maximum of 5 040 UVTs). If the PIT base is broadened as suggested by the TIC, the ceiling will become unnecessary and can be abolished. However, if the PIT base remains narrow, a TE ceiling could be maintained while ensuring that all voluntary contributions fall under its scope.

The TIC supports the policy stipulating that for business expenses to be deductible, they need to have been paid electronically and be verifiable with an invoice. This limits abuse of deductions by the self-employed, who can deduct all of their business expenses from their general income and thereby exceed the 40% ceiling. In addition, the TIC recommends greater monitoring and enforcement of these expenses. This would help strengthen compliance with both the income tax and VAT.

Although not discussed in this report, discussions with local tax experts have indicated that the tax residency requirements for individuals are not aligned with international practice and give rise to tax avoidance opportunities. The tax residency rules should therefore be reviewed, and possibly reformed, in accordance with leading international practice.

Abolishing TEs and broadening tax bases might not necessarily result in more tax revenues if taxpayers can easily classify their income in ways that allow them to use other TEs. The TIC recommends that the government should evaluate whether a tax base broadening reform could go hand-in-hand with a reform that lowers the tax rates in the medium term and equalises the tax treatment across different types of personal income. Simulations carried out for the report show that a broad PIT base with a basic allowance that equals (once or twice) the minimum salary with three PIT rates would raise significantly more tax revenue than the current PIT rate schedule and would allow a reduction in the top PIT rate to 25%. As the Commission's analysis has shown, the breadth of TEs in Colombia's tax system reflect systemic structural issues that require a fundamental PIT reform.

## Reform the tax treatment of pensions to restore equity and progressivity

Perhaps the largest inequity in the Colombian tax system is the tax treatment of pensions. While compulsory and voluntary private pension savings are deductible from taxable personal income at high marginal PIT rates, the pension itself is largely untaxed. The marginal effective tax rate on pensions is negative, and therefore the government subsidises pension savings. Moreover, this subsidy is regressive not only because it is significantly larger for higher incomes, but also because very few members of low-income households possess pensions.

There is ample scope for pension reform. The deduction of voluntary pension savings can be reduced and/or the pension itself can be taxed under the PIT (though below the current high exemption threshold), possibly jointly with labour income. Pension reforms should also avoid the double taxation of pension savings, i.e. that they are taxed once when the pension savings are made and then again when these savings are withdrawn in the form of a pension.

## There are significant VAT base broadening opportunities

Colombia's VAT grossly under-performs against its objectives. The VAT is intended to be a broad-based tax on final household consumption, but in Colombia its poor design – from extensive exclusions, exemptions and reduced rates, as well as low VAT compliance – results in a narrow VAT base. The Colombian VAT is consequently amongst the weakest performing VAT systems in the OECD: 62% of all potential VAT revenues go untaxed in Colombia, as compared to the expected revenues if all consumption was taxed at the standard VAT rate.

The Colombian VAT also places a significant burden on businesses. In particular, the non-recoverable VAT paid on fixed assets and the wide range of VAT exclusions increase the business tax burden and the cost of investment. That being said, the VAT on investment raises substantial revenues, which, if disregarded, would further weaken the VAT's current performance. To offset the distortionary effect of the VAT on investment, Colombia introduced a CIT credit for the VAT levied on investments in fixed assets as a step in the right direction as it avoids that the VAT increases a profit-making firm's cost of capital. While this is sub-optimal, as it does not tackle the VAT design flaws at source, the CIT credit should remain in place until such reforms enacted. A VAT reform that provides businesses with a VAT credit for the input VAT paid on investment in fixed assets will need to be accompanied with transitional rules. Businesses that have unutilised CIT credits for VAT paid on investment in fixed assets, which took place prior to the VAT reform, should maintain the right to use these credits to reduce their CIT liability. VAT paid on new investment should be credited against output VAT levied on sales.

The VAT on investment in fixed assets and other inputs increases the cost of doing business. It induces businesses to locate their production – for domestic consumption – abroad and/or buy inputs from overseas. Similarly for consumers, the VAT on investment steers them towards buying either foreign-produced goods or goods from the informal sector. This issue is prevalent throughout Colombia's economy, but is particularly acute in the agricultural sector. The government has excluded large parts of the agricultural value chain from VAT in an attempt to prevent unrecoverable input VAT being included in the prices that businesses charge on their sales to the agricultural sector, and consequently, in the prices paid by consumers of agricultural produce. This approach is ineffective, costly, and merely shifts the problem from the agricultural sector to the businesses that supply goods and services to the sector. A VAT reform for the agricultural sector could be developed once the VAT compensation mechanism has been more widely rolled out.

Furthermore, the current VAT design does not promote improvements in the health of the population nor environmental sustainability. Instead, Colombia has a number of VAT concessions for goods and services with negative externalities, including gasoline and diesel, and other goods that have negative environmental effects, as well as alcoholic beverages that generate negative health externalities. Lessons could be taken from the policy reforms seen in several OECD countries whereby tax authorities are applying, in addition to the standard VAT rate, excise duties to an increasing number of goods and services that are harmful to health and the environment.

Colombia also excludes certain provinces from the VAT in order to meet social policy objectives. However, this approach is sub-optimal as it does not contribute to the development of these poorer regions and induces tax evasion, as companies may be tempted to artificially route certain transactions through these provinces in order to try to benefit from VAT exclusions.

The TIC strongly recommends improving the design and functioning of the VAT regime. Core elements of reform should be to broaden the VAT base and reduce complexity. The VAT compensation mechanism creates an opportunity for a VAT reform. According to the Ministry of Finance, strong progress has been made in targeting – identifying and ranking – poor households through SISBEN. Expanding coverage of social transfers and increasing the value of compensation could help further reduce poverty.

Removing the numerous regressive and poorly targeted VAT expenditures that Colombia currently has in place would broaden the tax base immediately, decrease distortions, lessen complexity and reduce inequalities. If poor households can be directly compensated through a cash transfer programme, it is more efficient to tax all goods and services at the standard VAT rate and compensate the poor directly through cash transfers. If the compensation system cannot be fully implemented in the short run, the 0% reduced VAT rate can be maintained on a selection of items, including exports and the basket of basic needs goods, in order to satisfy the right to subsistence. Government could eliminate VAT exclusions – in particular those exclusions that are uncommon from an international perspective – and steadily increase the number of

items that are brought under the scope of the standard VAT rate of 19%. The VAT chapter in the report contains detailed information on the items that can be reformed in the short run.

The reduced VAT rate can also be increased. Instead of the low 5% rate, a reduced VAT rate of around 10%-12% would limit the number of firms that need VAT refunds and hence opportunities for VAT fraud. Goods and services that cannot immediately be taxed at the standard VAT rate, for instance because the compensation system cannot be fully implemented, could be taxed at the reduced VAT rate. These reforms would likely generate significant additional VAT revenues. Once the VAT compensation mechanism is able to reach all low-income households and the amount of the compensation is adjusted accordingly, the VAT base broadening can then continue by bringing additional basic goods within the standard, or if not possible, the reduced VAT rate. The standard VAT rate of 19% should not be increased, as the rate is not particularly low.

Some members of Congress have recently suggested abolishing the VAT and replacing it with a Consumption Tax. This type of reform would be a mistake. Instead, the National Consumption Tax can be abolished and the design of health and environmentally related excise duties can be improved. There are numerous examples of “low-hanging fruit” that could be rectified almost immediately, for example, the VAT exemptions on magazines. Other reforms, such as the interaction of the different indirect taxes as a way to finance local governments, may require more preparation but are important to implement.

## The design of the CIT is overly complex and requires fundamental reform

Colombia, like other Latin American countries, operates in an increasingly open environment where investors are faced with a number of choices of where to locate their activities. Business tax regimes can influence these choices and the current Colombian regime actively discourages inward investment. Reversing this trend requires broadening the tax base, lowering rates and reducing complexity. This, in turn, would enable DIAN to provide greater tax certainty and predictability on the tax treatment of both domestic and foreign investments.

Colombia’s business tax regime is characterised by a worldwide taxation regime, a high statutory CIT rate, wide ranging additional taxes, and extensive CIT expenditures that narrow the CIT base. The CIT is complex because of the special tax rules that have been introduced to offset the effects of the various non-profit based taxes that businesses have to pay, the TEs introduced to mitigate the distortive impact of the standard tax regime, and the preferential tax treatment that is provided to some sectors or types of investment.

Over recent years, the CIT rate has been reduced and some of the additional business taxes have been abolished, including the CREE, the alternative minimum tax and, to a large extent, the business wealth tax. However, Colombia continues to levy VAT on investment in fixed assets, a financial transaction tax, and a local business tax that is levied on turnover rather than on profits. These three taxes increase the cost of capital and the cost of doing business in Colombia. The financial transaction tax or “debit tax” is distortive, discouraging businesses from entering the formal economy and disincentivises foreign and domestic investment. Policy makers have attempted to offset the impact of these non-profit based taxes via tax deductions or tax credits within the CIT, and thus the TIC recommends that these TEs remain in place until the underlying distortions are resolved at source.

In an attempt to limit the tax burden on businesses, successive governments have introduced more business TEs, further increasing complexity and inequity. In recent attempts to stimulate investment and economic development, congress approved special tax regimes for mega-investments, hotels, and the exploration of mining and hydrocarbons. Not only have these TEs increased the tax system’s complexity and resulted in unfair competition across different sectors, they have also increased tax planning opportunities and enforcement costs. Instead of introducing additional TEs, Colombia needs to

fundamentally simplify its business tax regime and lower its standard tax rate, which, from an international perspective, reduces the country's competitiveness. Furthermore, Colombia's narrow tax base results in a wide range of tax planning opportunities. The ETRs that businesses pay vary widely, both across and within sectors. Businesses that do not actively engage in tax avoidance and, possibly, tax evasion face a competitive disadvantage compared to firms that are more aggressive in using and abusing tax loopholes and weaknesses in the tax administration.

Rather than tackling distortions through the introduction of TEs, Colombia should resolve the challenges at source by designing a CIT regime that is competitive for all sectors. It would be naïve to think that many CIT incentives can be removed from the tax code in the short run. Instead, Colombia needs a fundamental business tax reform that broadens the tax base and simplifies the tax system, aligns the tax treatment across sectors, abolishes distortive non-profit based taxes, eradicates the CIT recapture tax and lowers the standard CIT rate significantly for all businesses. A fundamental business tax reform could include a reform of the taxation of personal capital income that would allow a partial shift in the burden of capital taxation from the corporate to the individual investor level.

Colombia should seek to align its tax system with changes in the international tax landscape. Recent advances in the design of the VAT on cross-border sales of digital products creates an opportunity to broaden the VAT base, for example, while the increasing use of tools permitting the Automatic Exchange of Fiscal Account Information for Tax Purposes can allow Colombia to start taxing the capital income held offshore by its tax residents. In addition, the possible introduction of a global minimum tax under Pillar II of the project on the Tax Challenges Arising from Digitalisation as part of the OECD/G20 Base Erosion and Profit Shifting project will have an impact on how Colombia will want to design its tax expenditures.

## Reforms should enable the CIT recapture tax to be abolished in the medium term

The CIT recapture tax (i.e. the dividend withholding tax levied on untaxed corporate profits) is an uncommon approach to protecting the tax base. In order to prevent firms distributing dividends that have not been taxed at the CIT rate, the government has introduced the CIT recapture tax. This tax offsets a wide range of TEs that are in place, including those for non-taxable income, exempt income, and deductions that exceed actual costs. While the CIT recapture tax protects tax revenues and corrects for the large opportunities businesses have to limit their tax liability, it is imprecise in achieving its policy targets, also offsetting the impact of TEs that have positive efficiency characteristics such as accelerated tax depreciation allowances.

As the CIT recapture tax does not offset the impact of tax credits, Colombia should consider turning the deduction of the financial transaction tax into a tax credit in order to allow businesses to benefit from it, even when they distribute dividends. This approach could be followed for TEs that correct for weaknesses in the design of other elements of the tax system, in particular, such as the financial transaction tax.

The CIT recapture tax has also increased the complexity of the tax system and has unintended distortive effects. Among those effects is the tax-induced incentive for businesses not to distribute dividends. This is particularly significant as capital gains are taxed more favourably than dividends at the individual level, and thus creates a tax distortion in favour of large mature firms over start-ups and fast growing firms that need to attract external financing.

There is an argument to be made for maintaining the CIT recapture tax until the CIT base is significantly broadened and the majority of the exempt incomes are taxed as regular business income. However, once the design of the CIT has been improved, the CIT recapture tax should be abolished. Indeed, the rationale for the CIT recapture tax has already become weaker since Colombia has started taxing dividends at the personal shareholder level. A significant CIT base broadening reform that would only maintain a limited number of well-designed TEs could therefore go hand-in-hand with abolishing the CIT recapture tax.

## Significantly reduce the number of exempt and non-taxable income items

There are significant tax base broadening opportunities within “non-taxable” income and capital gains items, as well as the “exempt” income and capital gains within the CIT and PIT. Notably, the division of items into the categories “non-taxable” income, “exempt” income and capital gains is not a practice followed by any other OECD country, and reflects the complexity of Colombia’s tax system. Similar to other areas of reform, some TEs call for immediate action while others would be better addressed as part of a fundamental reform of the capital income tax system, both at the corporate and personal shareholder level. With the abolishment of the presumptive income tax, the distinction itself can be abolished too. DIAN should also begin estimating the tax revenue foregone of all of the non-taxable items considered as TEs under a TE benchmark. Currently, none of the non-taxable income items are measured in the TE report and therefore the value of revenue foregone is underestimated.

The valuation rules that apply to assets need to be reformed. In many cases, the value of assets is based on historical values that are not aligned with the market value of the asset, resulting in low tax liabilities. Instead, government should apply the market value when the assets are sold to determine the tax liability. The planned introduction of digital technologies in the coming years should aid DIAN in transitioning from historical to market values in a progressive manner that is neither too speedy, as to unduly shock taxpayers, nor too slow, as to prevent enduring and effective reform.

## Rollout SIMPLE across all small firms

The standard business tax regime could be complemented with a presumptive business tax regime, such as SIMPLE, targeted at small businesses. The stated objective of SIMPLE is to incentivise businesses to enter the formal economy and to ensure that their workers have access to health and pension entitlements; the TIC very much welcomes this approach. In fact, if an extension of SIMPLE were to be accompanied by a more service-orientated approach from DIAN – with tax officials assisting micro enterprises with access to government benefits and financial programs – the incentives for enterprises to join the formal sector would be further strengthened.

Nevertheless, there is room to improve the design of SIMPLE. Once businesses have chosen the SIMPLE regime, they should be obliged to stay within the regime for a specified period of time. SIMPLE should include all small firms across all sectors. This would allow the regime to play its role in inducing small businesses across sectors to enter the formal economy and to register workers within the social security system.

Whilst complimentary of SIMPLE on the whole, the TIC found the regime’s maximum turnover ceiling to be unusually high. Currently, businesses can opt for the SIMPLE regime if their turnover is below 80 000 UVT (about USD 771 000 or COP 2.849 million), a relatively high threshold for even medium-sized businesses in Colombia – most businesses with that level of turnover should be able to pay the regular CIT. However, as SIMPLE has already been introduced, lowering the turnover ceiling at this stage could discourage informal businesses from entering the regime. The Commission therefore holds the view that the SIMPLE turnover ceiling could be maintained in the short term, but DIAN should ensure that the regime cannot be abused and that businesses that opt into SIMPLE provide the necessary information to prove their earnings are below the ceiling. An independent analysis of the value the SIMPLE ceiling should be set at, which includes the budgetary implications of any decision, would help provide guidance for reforming the turnover threshold in the medium term.

Furthermore, businesses that file a SIMPLE tax return with turnover above the VAT threshold may not be able to recover the input VAT paid on investment in fixed assets as they cannot benefit from the CIT credit in relation to the VAT paid on investment (as they are liable for SIMPLE instead of the CIT). Rather than

introducing another credit within SIMPLE, government should restore the functioning of the VAT and provide a timely refund for input VAT that can be credited against the VAT levied on sales.

## Abolish the local business turnover tax ICA

The local business turnover tax (ICA) is a particularly distortive tax that should be abolished. Because it is levied on turnover instead of profits, it forces businesses with a high turnover but low profit margin to face a very high effective tax rate levied on their profits. However, removing the tax would create funding issues for local administrations who rely heavily on its revenue streams. Therefore, until local governments are funded through less distortive taxes, such as recurrent taxes on immovable property, and/or larger grants from central government, the tax credit within the CIT for the local turnover tax ICA should be maintained, despite the fact that it reduces the revenue raising potential of the CIT. Only profitable businesses can benefit from the tax credit, so the distortion of the ICA is not entirely corrected for with the CIT credit. Notably, the 100% tax credit can encourage territorial entities to increase the ICA rate to maximise their revenue compensation, again highlighting the distortive nature of the business turnover tax, and reinforcing the need to abolish the ICA as soon as possible.

Instead of compensating large businesses for their ICA liability through a CIT credit, government could increase the grant it provides to local governments, which would compensate local governments for the loss in tax revenues when they abolish the ICA. For small firms, the government already pays part of the revenues it raises from SIMPLE to local governments to compensate for the fact that SIMPLE replaces ICA for businesses with turnover below 80 000 UVT. The government therefore has all the necessary tools available to abolish the ICA and improve the business climate. But, as pointed out, this will require a change in the way central government funds local governments.

## Maintain the Free Trade Zone regime but bring FTZ businesses under the regular VAT regime, and remove the CIT exemption for International Logistic Distribution Centres

There are strong arguments for maintaining a Free Trade Zone (FTZ) regime in Colombia, as long as the standard business tax regime remains uncompetitive. Despite recent efforts to improve the design of the business tax regime, the tax burden on businesses remains very high. This, in turn, creates hurdles for both domestic and foreign investment.

Colombia's FTZs are classified into three categories: Permanent FTZs, Special Permanent FTZs and Transitional FTZs. Investment and job creation requirements vary widely between PFTZs and SPFTZs, as well as across sectors. Colombia has created 113 separate FTZs, the largest number in all Latin American countries bar the Dominican Republic. The proliferation of FTZs is largely explained by the fact that Special Permanent FTZs are single-company FTZs and are spread across the country rather than being confined to specified regions and sectors.

The introduction of FTZ regimes has contributed to growth, investment and increased employment, and therefore compensated somewhat for the lack of competitiveness of the business tax regime. However, 75% of total investment in FTZs is domestic and relatively few foreign MNEs are using the regime. Moreover, the expansion of FTZs into almost all sectors and regions of Colombia has created tax challenges, in particular because the current FTZ design undermines the proper functioning of the VAT. These challenges are related to the fact that Colombia has given Free Trade Zone (FTZ) status to businesses that do not belong under such a regime as they mainly produce for and sell to the domestic market.

Rather than deepening the TEs for FTZs, or creating other FTZ regimes, Colombia's key priority should be to make the standard business tax regime more competitive so that the country no longer needs to (mis-) use the FTZ regime to provide preferential tax treatment to businesses that are serving the domestic

economy. Reforming business taxes would then allow for the FTZ regime to merge with the regular CIT regime over time.

Before 2020, FTZ businesses that sold goods to the domestic economy did not have to file a VAT return. Although this design flaw was recently rectified, the current VAT rules for FTZs continue to represent poor practice. In particular, the VAT rules for FTZs lead to a high risk of fraud, shift the burden of VAT onto domestic businesses that sell to FTZ businesses, and increase DIAN's enforcement costs. Because Colombia has extended the FTZ status to businesses that mainly serve the domestic market and because these businesses are not grouped in special economic zones but are found across the entire country, the FTZ businesses should be brought within the regular VAT regime. This is particularly important for new FTZ businesses, but should also be extended to existing FTZ businesses if feasible. However, if the VAT treatment of existing FTZs cannot be changed, the government should definitely not create any new Special Permanent FTZs in the future.

VAT rules should apply for transactions from the domestic economy to a FTZ business (rather than being exempted) as well apply to the imports of FTZ companies. This reform could be accompanied by the introduction of a system that allows FTZ businesses to defer the payment of VAT on imports from abroad, and a duty drawback provision under which import duties are refunded upon the exportation of qualified articles. In addition, the functioning of the VAT should be strengthened, in particular by providing a full credit for the input VAT on investment against output VAT in a timely manner.

The rationale for the Transitory Free Trade Zone regime seems weak. Special customs rules should be designed rather than having a specific FTZ regime, as the objective of these benefits is to simplify customs procedures. Furthermore, the TIC believes that the CIT exemption for International Logistic Distribution Centres should be abolished, as the tax exemption is not aligned with the international trends towards a global minimum tax. FTZ businesses are obliged to report taxable income and any other information to DIAN in the same way as other businesses in the national economy. This is good practice and should be continued. Data from DIAN now show that the tax revenue foregone of the reduced CIT rate for FTZs is very low. This indicates that either FTZ companies are not very profitable or that they use other TEs that reduce their taxable income.

## Develop a whole-of-government development plan for the agricultural sector

Colombia implements a wide range of TEs for the agricultural sector. The tax revenue foregone of these incentives is small because the sector is largely informal and operates outside of the tax system. TEs targeted at the agricultural sector largely miss their objective and do not reach the businesses and farmers that need the support the most. Rather than using the tax system, government should develop an action plan that tackles the problems of the agricultural sector directly.

The tax-deductible workforce cost equivalent to 40% of taxable income for coffee growers needs to be abolished. Rather than deducting their true labour costs, as firms are able to do for the pension and health insurance contributions of workers registered with the Tax Authority, coffee growers have a deemed tax-deductible workforce cost equivalent to 40% of taxable income to account for their largely informal workforce. But this TE generates large negative external effects as it takes away the incentive and obligation for employers to hire workers in the formal sector. Employers should instead be encouraged to organise their activities in such a way that their workers enter the formal economy, and contribute to, as well as benefit from, health and pension entitlements. This could be achieved by agricultural firms registering under the SIMPLE regime.

The government has recently attempted to stimulate economic growth through the introduction of profit-based TEs such as ZOMAC (Zones Most Affected by Conflict) and ZESE (Special Economic and Social Zones), rather than tackling the problems of rural areas at source. These solutions are ineffective and should be

avoided. Instead, Colombia needs a regional development plan that addresses the structural difficulties the agricultural sector and the countryside face, such as the need for significant and prolonged investment in infrastructure of all forms: communications, power and energy, transport, water, and waste. These programmes should be complemented by TEs, including a switch to using cost-based rather than profit-based TEs, which are more likely to encourage new business, stimulate investment, and the achievement of specific policy objectives. One important non-tax measure that should accompany tax reforms is incentivising farmers to register their property in order to improve domestic stability, decrease the likelihood of evictions. Government should facilitate registration by reducing the tax and non-tax costs of registration.



## Box 1. The commission's reform recommendations fall into five key areas

### 1. The Commission's general recommendations

- Engage in fundamental tax reform rather than making incremental tax changes within each tax;
- Broaden the tax base significantly, reduce tax complexity, increase tax revenues and in the medium term lower statutory tax rates;
- Increase the effective progressivity of the tax system and reduce tax-induced distortions;
- Improve the tax policy making process and stop misusing the tax system to tackle problems that lie beyond the scope of the tax system;
- Publish an annual stand-alone TE report and continue improving the methods used to calculate the tax revenue foregone of TEs on an item-by-item basis; develop a benchmark tax system so that TEs can be identified and proposed measures costed; ensure that DIAN has all necessary data and resources to carry out these tasks.

### 2. Enhance the role of the PIT

- Significantly reduce the number of exempt and non-taxable income items within the PIT; treat all payments made by the employer to employees as taxable personal income, including voluntary employer pension and health contributions, payments for the education of the children of the employee and abolish the special tax treatments that certain professions receive;
- Broaden the PIT base significantly; abolish the deduction of most “non-standard” tax reliefs, and, for the deductions that are maintained, introduce a maximum ceiling (for each TE separately); avoid the use of tax allowances that increase with income, i.e. those that are a percentage of total income;
- Where a decision is taken to maintain a tax expenditure that currently takes the form of a tax allowance, consideration should be given as to whether this should be converted into a tax credit;
- Reform the PIT rate schedule by lowering the basic tax allowance and reducing the number of PIT brackets; avoid increasing statutory PIT rates. A significantly broadened PIT base would allow a reduction in the statutory PIT rates while raising up to 2% of GDP in additional PIT revenues;
- Strengthen tax enforcement to ensure that pension and health contributions are paid on all labour income by all types of workers, including the self-employed, and that the self-employed do not deduct private consumption as business expenses from taxable personal business income;
- Partially shift the tax burden on capital income from the corporate level towards the personal shareholder level; improve the design of the taxes levied on personal capital income;
- Continue to embrace the automatic exchange of tax information to ensure the fair taxation of capital income, irrespective of whether income is earned and assets are held in Colombia or offshore;
- Tax pensions at an effective rate that is fair.

### 3. Broaden the VAT base and improve its design

- Reduce the number of excluded and exempted goods and services, in particular those that are not in accordance with international practice, and bring as many as possible within the standard VAT rate of 19%;
- Do not increase the standard VAT rate further;
- If poor households can be compensated directly through the VAT compensation mechanism, it is more efficient and fair to tax all goods and services at the standard VAT rate and compensate the poor directly through cash transfers;
- If the compensation system cannot reach all the poor in the short run, continue to tax the basket of basic need goods that are consumed by the poor at a 0% rate in the short term. When the mechanism has reached all the poor, use the opportunity to further broaden the VAT base and increase the value of VAT compensation accordingly;
- Tax a considerably larger number of items at the standard VAT rate, which are currently taxed at the reduced VAT rate. Increase the current reduced VAT rate from 5% to a rate in the range of 10% to 12% to reduce the number of firms that are entitled to a VAT refund, hence reducing opportunities for fraud. Excluded and exempted goods and services that cannot immediately be taxed at the standard VAT rate should be taxed at the reduced rate first;
- Ensure that businesses receive a credit against the VAT levied on sales for the VAT they have paid on investment in fixed assets; provide this credit within the VAT rather than via the CIT, as is currently the case. In order to prevent a drop in VAT revenues, explore whether the VAT on investment can be credited gradually over time from VAT levied on sales rather than in the year when the investment took place. Move gradually to a full refund in the year when the input VAT was paid and strengthen the VAT refund system. Accompany the VAT reform with transitional rules that allow businesses to deduct the unutilised CIT credits for VAT paid on prior investment from future CIT liabilities. However, as long as the VAT design is not improved, do not abolish the CIT credit for VAT on investment;
- Increase taxes on goods and services that harm individuals' health and the environment; work towards abolishing the National Consumption Tax and levying VAT and specific excise duties instead;
- Bring Free Trade Zones (FTZs) within the standard VAT regime, in particular the single business FTZs (Special Permanent FTZs). If this is not feasible, then abolish the single-business FTZ regime or, at least, do not create new single-business FTZs;
- Introduce a system that allows FTZ businesses to defer the payment of VAT on imports from abroad, and a duty drawback provision under which import duties are refunded upon the exportation of qualified articles.

### 4. Improve the design of the CIT and avoid non-profit based business taxes

- Abolish the local business turnover tax and strengthen the design of the VAT (see above) so that it no longer increases the cost of investment. Abolish the financial transaction tax or turn it into a tax on cash withdrawals only. Maintain the corresponding CIT credits and deductions until these distortions have been resolved;
- Align the tax treatment of businesses across different sectors and avoid the use of TEs and special tax rules targeted at specific sectors, including reduced CIT rates and profit-based TEs;

- Significantly broaden the CIT base, and, eventually, abolish the CIT recapture tax;
- Lower the standard CIT rate to a level that is competitive from an international perspective;
- Maintain the FTZ regimes, but seek to merge the FTZs within the standard CIT regime in the long-run, once the design of the CIT has been made at least as competitive as the FTZ regimes;
- Perform a cost-benefit analysis of the CDLIs to evaluate whether the regime could be maintained.
- Allow all small companies to enter the SIMPLE regime, and promote the regime to sectors where SIMPLE has a low take-up rate, such as the agricultural sector.
- Simplify the design of SIMPLE, but do not introduce an additional simplified regime that sits in between SIMPLE and the standard business tax regime; do not introduce a credit for the VAT on investment within SIMPLE, but reform the VAT instead;
- Strengthen the agricultural sector's formalisation strategy as part of 2018-2022 National Development Plan and the framework of Territorially Focused Development Plans, and include tax and non-tax measures that tackle the problems of the agricultural sector at source; facilitate the registration of farmer's property by reducing tax and non-tax registration costs;
- Redesign profit-based TEs designed to aid rural areas into cost-based TEs – this applies to ZESTE and ZOMAC, which require reforming.

## 5. Other tax-related reforms

- Create an independent group of tax and public finance experts to develop a strategy for implementing the findings of the TIC's report and assess future tax reform proposals, in collaboration with the MOF and DIAN;
- Strengthen evidence-based tax policymaking and increase the use of individual and business tax return data to analyse the tax system;
- Continue to digitalise operations and services under DIAN's on-going modernisation strategy; gradually roll-out electronic invoicing and payment methods across the economy; and further develop risk-based auditing tools to ensure that all taxpayers pay their correct share of tax and use all information available to carry out this task;
- Develop a country-wide Fiscal Cadastre and start levying recurrent taxes on immovable property across the entire country; exempt low-value properties from property tax;
- Use market values rather than historical values to determine taxable income;
- Avoid financing sub-central levels of government through distortive taxes.



# Setting the Scene

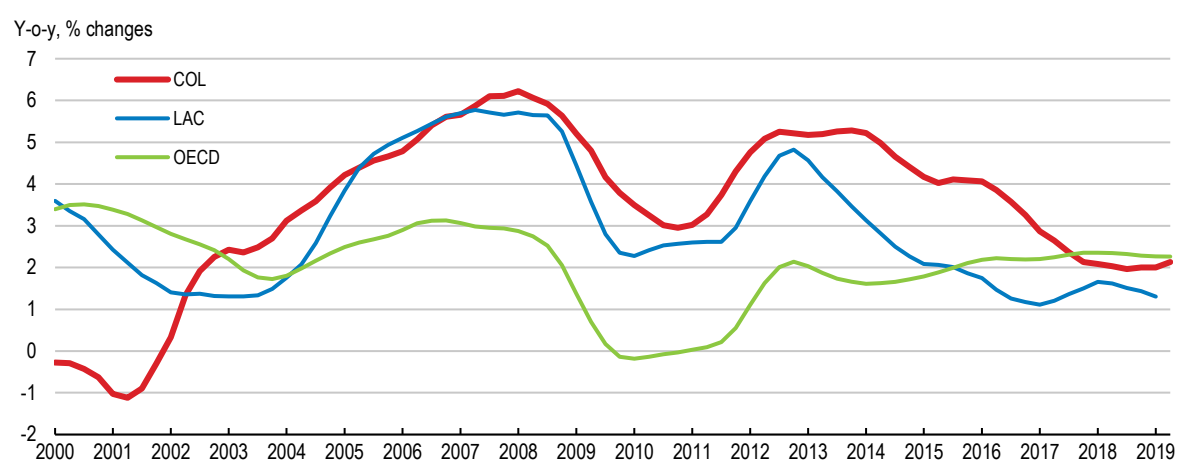
Tax Expenditures Report



# 1 Setting the Scene

Setting the Scene Colombia has made good economic and social progress over the last two decades. Sound macroeconomic policies, alongside favourable demographics and external conditions, underpinned resilient economic growth prior to COVID-19 (Figure 1.1). This has contributed to higher living standards and, together with improving access to education and social transfers, brought significant social improvements. Poverty has fallen markedly in recent years, though efforts to reduce inequality have had less impact.

**Figure 1.1 – GDP growth over the last two decades**

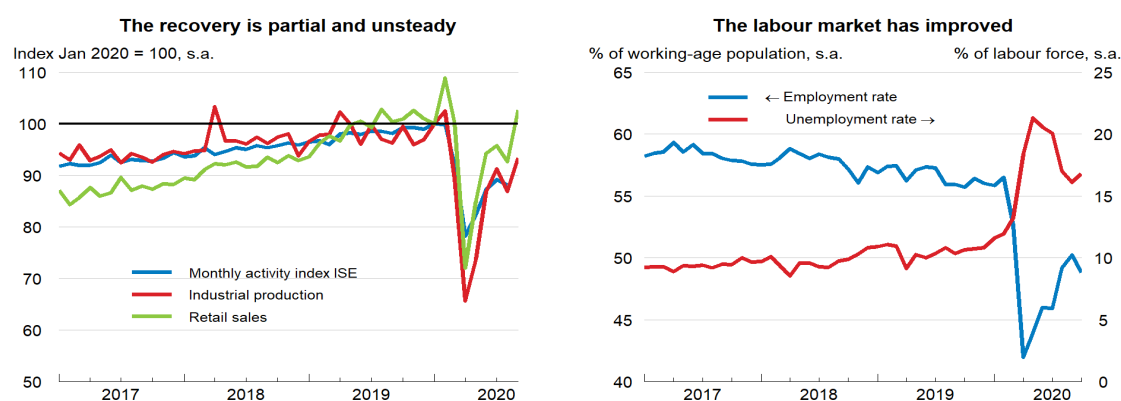


Note: LAC refers to the unweighted average of Argentina, Brazil, Chile, Costa Rica and Mexico. Data show a 3-year moving average of year-on-year percentage changes.

Source: OECD Analytical database; World Bank, World Development Indicators database.

However, the COVID-19 pandemic has severely disrupted Colombia's economic progress. Similar to other OECD countries, Colombia's GDP fell 6.8% in 2020, driven by domestic confinement measures, the global economic contraction, lower oil prices, and tightening financial conditions. The recovery will likely continue to be moderate, led by improvements in consumer confidence and a gradual recovery of investment. A weak external environment, however, may keep trade depressed and raise vulnerability to already low commodity prices. GDP is projected to rise by 3.5% in 2021 and 3.8% in 2022 (OECD, 2020<sub>[1]</sub>).

**Figure 1.2 – The economy is projected to suffer its deepest recession in a century in 2020**



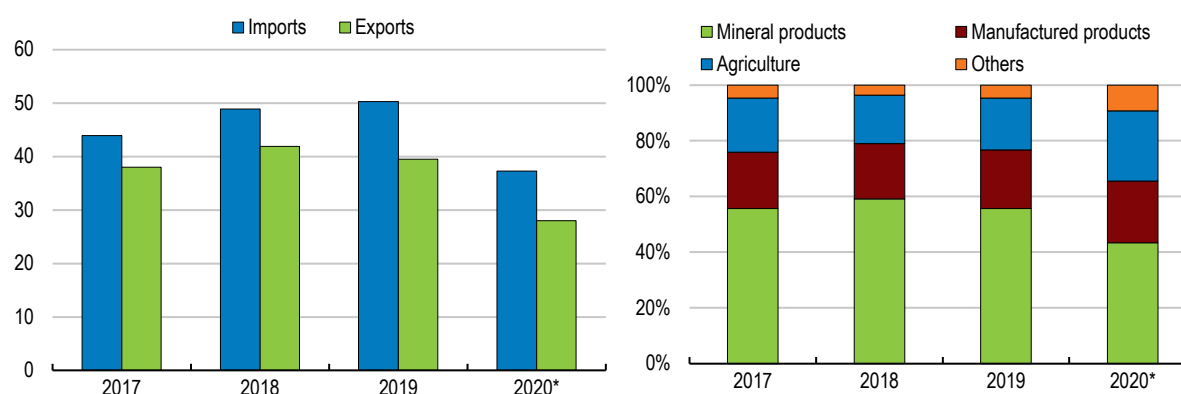
Source: OECD Main Economic Indicators database; DANE (Colombia); and Banco de la República (Colombia) (OECD, 2020<sup>[1]</sup>).

Following years of relative balance, the COVID-19 crisis has increased Colombia's fiscal deficit substantially. In the 15-year period leading up to 2020, the government budget deficit averaged -2.7%, supported by a debt to GDP ratio of 39.8%. The government has been widely commended for its response since the outbreak of COVID-19, responding with interest rate cuts, bond purchases (quantitative easing), relief to banks; fiscal spending on strengthening health care, transfers to vulnerable households and labour interventions (OECD, 2020<sup>[2]</sup>). However, this has inevitably led to a significant increase in its budget deficit and debt to GDP ratio. By 2022 public debt is expected to rise by almost 15 percentage points to above 60% of GDP (OECD, 2020<sup>[1]</sup>). In addition, equity markets have fallen sharply, the government risk premium has risen and the peso has weakened notably in the first half of the year amid large capital outflows and increased uncertainty. Alongside substantially lower oil prices, these events have put considerable pressure on Colombia's external and fiscal accounts and underlined the importance of fiscal sustainability and the ability to raise revenues in the future.

The subdued global economic environment also risks hampering Colombia's recent efforts to open up its economy. The country has sought to promote integration into the global economy via trade agreements to catch-up with other emerging economies, who are relatively more integrated into international trade networks. However, exports remain comparatively limited – in 2018, total Colombian exports were valued at 15.9% of GDP, notably below the LAC and OECD averages (22.2% 28.8%, respectively), and behind regional competitors Costa Rica (33.7%) and Mexico (39.2%) (OECD, 2019<sup>[3]</sup>) – and large parts of the economy are shielded from international competition through higher tariff and non-tariff barriers than regional peers. Exports of mineral products fell during 2020 both in real terms and as a percentage of total exports (representing approximately 50% of Colombia's total exports) as did manufacturing exports. Although there is room to diversify exports and make trade a source of growth and productivity enhancing competition, internal factors also limit Colombia's ability to compete in international markets. For example, the costs of exporting are high due to infrastructure gaps and weak logistic networks.

Colombia's labour market, already subdued following the pre-2020 growth deceleration, has suffered greatly from the impacts of COVID-19. Prior to the pandemic, employment grew at an average annual rate of 3% between 2008 and 2018. The unemployment rate, which had edged above 10% before the crisis to amongst the highest levels in Latin America, rose to approximately 20% at the end of Q2 2020 before improving to around 17% by Q4 (see *Figure 1.2*). Progress had been made in increasing participation rates, but this has now gone backwards, particularly in urban areas and among the youth population. Colombia's labour market must also contend with the longstanding difficulties of its extensive informal sector and the more recent challenge of integrating a greater number of migrants from Venezuela.

**Figure 1.3 – Imports and exports in USD thousand millions, and Exports structure**

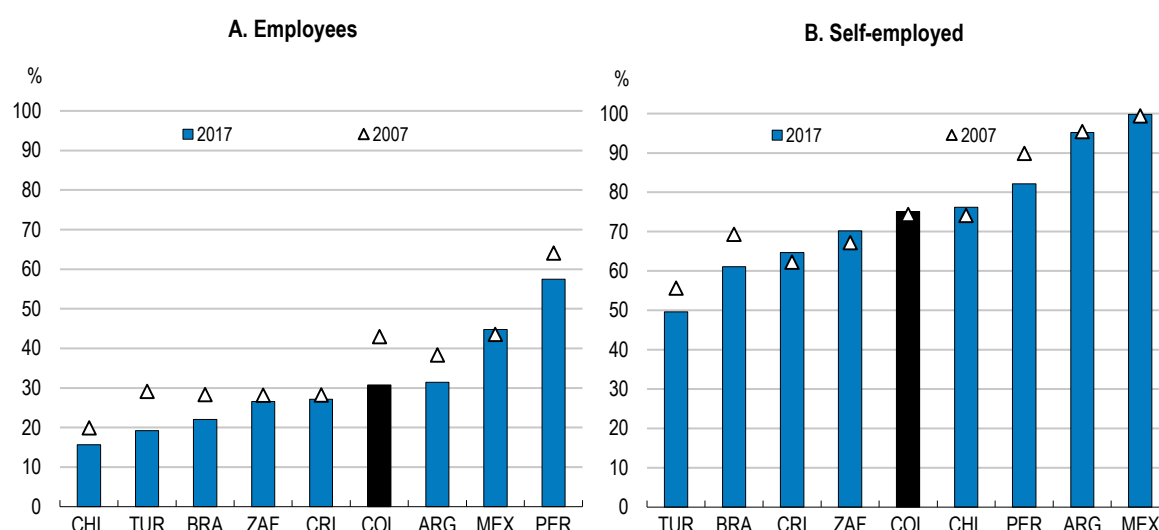


Notes: 2020 figures represent data from January to November.

Source: DIAN

Colombia has achieved a significant reduction in informality over the last decade, though it remains prevalent across the economy. The share of the overall workforce that does not contribute to social security payments dropped from approximately 70% in 2007 to 62% in 2017 (IMF, 2018<sup>[3]</sup>) – a level that is broadly in line with other countries in the region, but is nonetheless high (OECD, 2019<sup>[4]</sup>)<sup>1</sup>. As shown in *Figure 1.4*, labour informality is largely driven by informal self-employment, with those with lower education and skills far more likely to be employed in the informal sector. In Colombia, a worker with a postgraduate degree is nine times more likely to participate in the formal sector than a worker without any education, and twice as likely as a worker with a high school degree. A number of existing taxes and regulations, such as the high tax burden on formal businesses, also contribute towards informality by creating a wedge between the cost of operating in the formal and informal sectors (Sorsa, Arnold and Garda, 2019<sup>[5]</sup>). Evaluations of the 2012 payroll tax reform emphasise this point, illustrating that informality was notably reduced by the improvements in the tax regime (Kugler, Kugler and Herrera-Prada, 2017<sup>[6]</sup>).

**Figure 1.4 – Informality has fallen notably, but remains elevated among the self-employed**



<sup>1</sup> Estimates suggest that between 20-40% of GDP is produced by the informal sector (Medina and Schneider, 2018<sup>[12]</sup>; ANIF, 2017<sup>[13]</sup>).

Note: Informality is defined to include: i) employees who do not pay health contributions; and ii) self-employed who do not pay social security contributions (Brazil, Chile and Turkey), or whose business is not registered (Argentina, Colombia, Costa Rica, Mexico, Peru and South Africa). Data for Turkey refer to persons aged 15 and more. Data for Argentina refer to selected urban areas (according to the National Statistical Authority (INDEC), LFS series published after the first quarter of 2007 and until the fourth quarter of 2015 must be considered with caution).

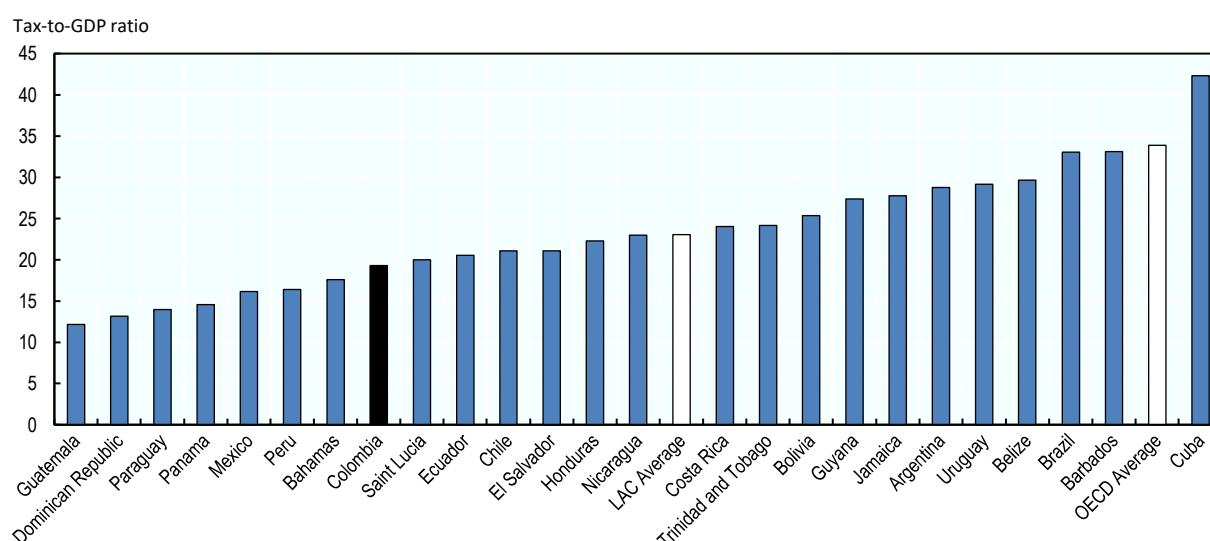
Source: Calculations are based on the EPH for Argentina, the PNAD for Brazil, the CASEN for Chile, the GEIH for Colombia, the ECE for Costa Rica, the ENOE for Mexico, the ENAHO for Peru, the QLFS for South Africa and the HLFS for Turkey.

## 1.2 Tax mix

Raising tax revenues in a more efficient and fair way has been a long-standing challenge in Colombia (OECD, 2019<sup>[4]</sup>). There have been 12 tax reforms in the last 20 years, but the tax system remains complex, with numerous special regimes and tax exemptions. The latest reforms, enacted in December 2016 and December 2019, included reducing the corporate income tax (CIT) rate, eliminating the business wealth tax, increasing the VAT rate and measures to reduce tax evasion, and have widely been acknowledged as steps in the right direction (OECD, 2019<sup>[4]</sup>). Nevertheless, tax revenues in Colombia remain comparatively low and the tax burden falls predominantly on businesses.

Colombia's tax-to-GDP ratio is low in comparison to the OECD average as well as other LAC countries (Figure 1.5). In 2018, Colombia's tax-to-GDP ratio was 19.4%, 3.6 percentage points below the LAC average (23.1%)<sup>2</sup> and significantly below the OECD average (34.3%). Improvements in Colombia's tax-to-GDP ratio both in the short and longer-term are in line with the LAC average (see Figure 1.6), but it has never surpassed 20% since 2000, when the ratio was as low as 15.7%.

**Figure 1.5 – Tax-to-GDP ratio's in LAC countries in 2018**

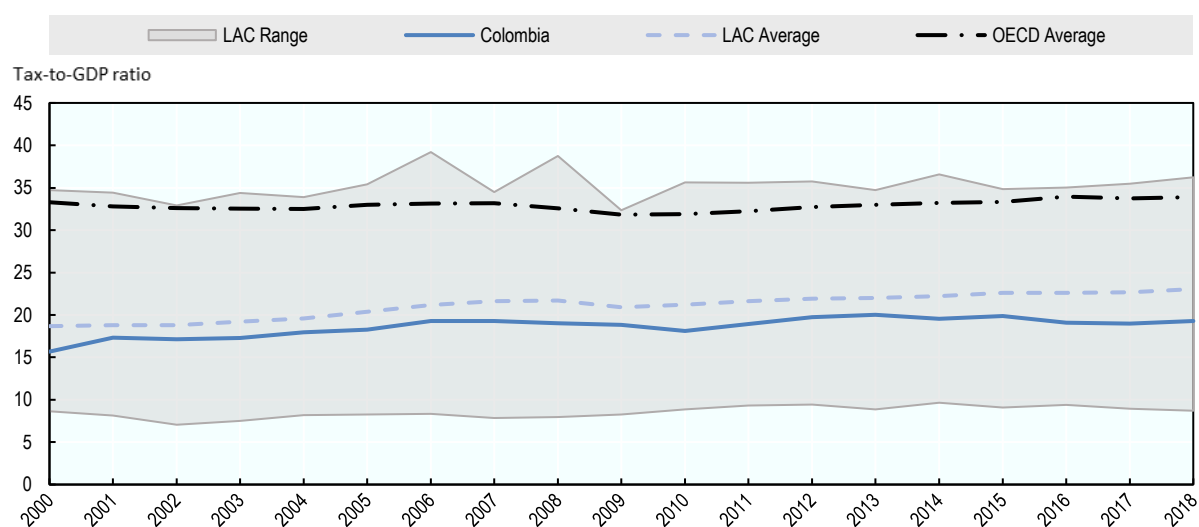


Source: OECD Global Revenue Statistics Database (OECD et al., 2020<sup>[7]</sup>)

<sup>2</sup> Represents the unweighted average of 25 Latin American and Caribbean countries included in the Revenue Statistics in Latin America and the Caribbean 2020 report and excludes Venezuela due to data availability issues.



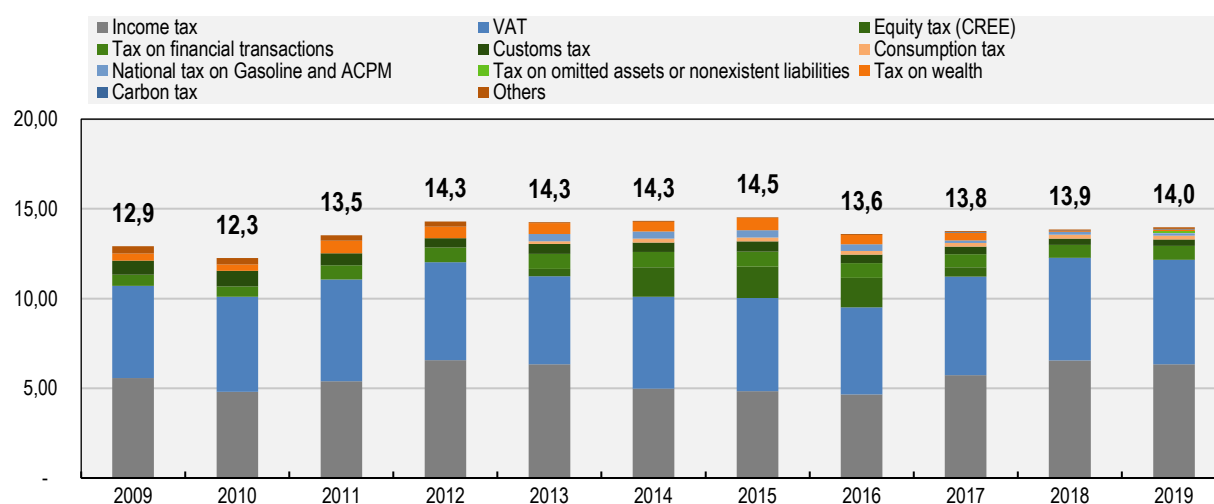
**Figure 1.6 – Tax-to-GDP ratio in Colombia compared to the LAC and OECD average over time**



Source: OECD Global Revenue Statistics Database (OECD et al., 2020<sup>[7]</sup>)

Figure 1.7 provides a detailed overview of the tax-mix in Colombia over the last decade and their respective contributions to tax revenues (not including revenues from SSCs) as a percentage of GDP. The figure shows not only that income tax (including both PIT and CIT) and VAT have consistently contributed the largest share of total tax revenues, but that Colombia employs a large number of additional taxes that raise relatively limited revenues; many of which are uncommon in OECD countries. The figure also shows that many taxes that raise significant revenues in other OECD countries, such as recurrent taxes on immovable property and health and environmentally related excise duties are largely absent from the tax mix. .

**Figure 1.7 – Colombia levies a wide variety of taxes (revenue contribution as a % of GDP)**

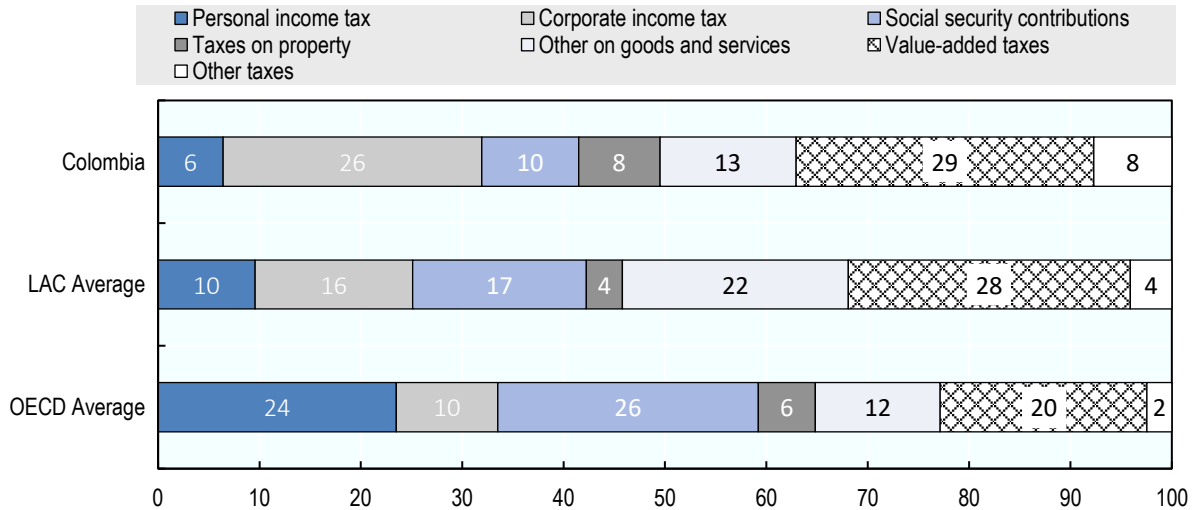


Source: DIAN and Ministry of Finance

The revenues collected from the personal income tax (PIT) contribute a relatively low share of total tax revenue (6%), both in comparison with other countries in the region and with the OECD average (24%) (Figure 1.8). On the other hand, the revenues from the CIT make up 26% of total tax revenues, which is

significantly above both the LAC average (16%) and the OECD average (9%). Colombia also raises a larger share of its revenue from taxes on property (8%) compared to both the LAC average (4%) and the OECD average (6%). The highest share of tax revenues in Colombia in 2018 was derived from value added taxes (VAT) (29%), which is similar to the LAC average (28%).

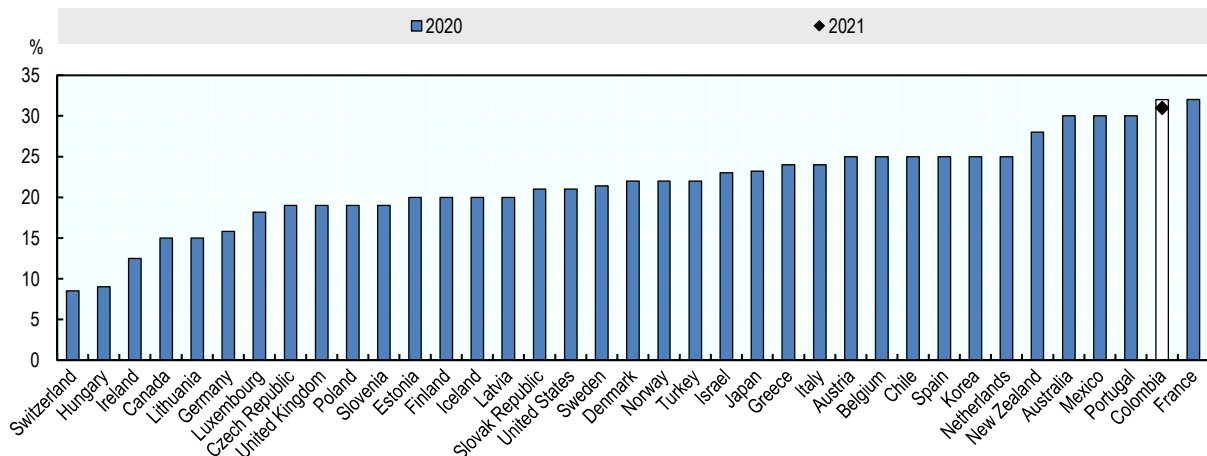
**Figure 1.8 – Compared to other LAC and OECD countries the tax mix is disproportionately reliant on the corporate income tax (2018)**



Source: OECD Global Revenue Statistics Database (OECD et al., 2020<sup>[7]</sup>)

Businesses face a disproportionately high tax burden in Colombia in part due to the comparatively low level of revenues raised from other taxes, but also because Colombia has a high statutory CIT rate compared to other OECD countries and a wide range of non-profit based taxes, which discourage investment and weaken the business climate. Under the 2019 tax reform, CIT rates will decrease from 32% in 2020, to 31% in 2021 and 30% from 2022 onwards. Furthermore, the presumptive income tax rate was reduced from 3.5% in 2019 to 1.5% in 2020, and will be removed from 2021 onwards. However, *Figure 1.9* shows that even with lower future rates, Colombia will continue be among the OECD countries with the highest CIT rates (Australia and Mexico have a CIT rate of 30%, and in France, it is 32%).

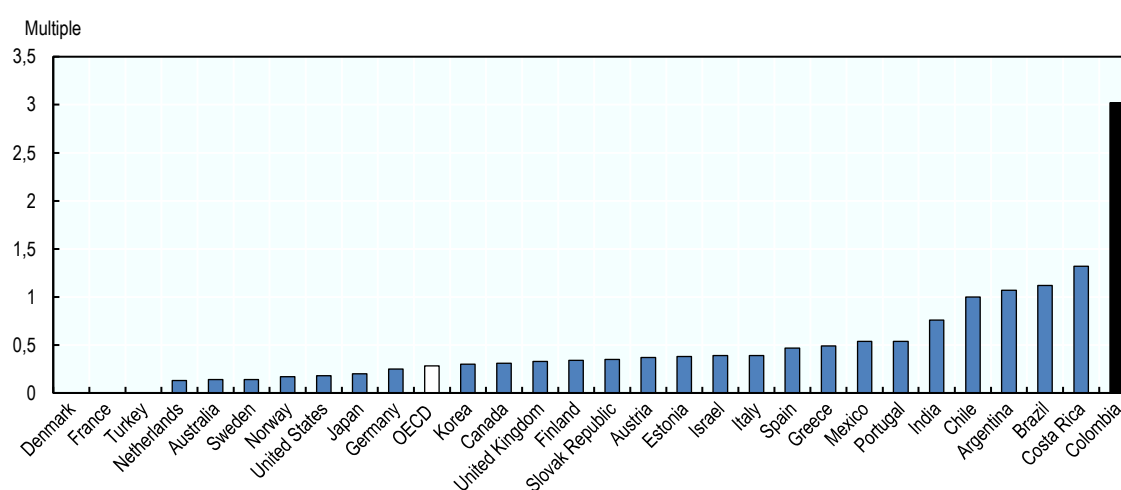
**Figure 1.9 – Statutory CIT rates in OECD countries**



Source: OECD Corporate Tax Statistics Database and DIAN

**In contrast to the CIT, the PIT yields a low share of tax revenue, in comparison with both LAC and OECD countries.** Very few individuals pay PIT, or even submit an end-of-the-year tax return. This is due to a high income-threshold below which no PIT has to be paid, and the wide range of PIT tax expenditures (TEs). In Colombia, the PIT hits at an income just above three times the average wage (Figure 1.10). While the level of the income-threshold below which no PIT has to be paid cannot be seen in isolation from the purchasing power that corresponds to the average salary, the current threshold in Colombia seems excessively high. For comparison, the OECD average income-threshold below which no PIT is levied is 0.28 times the average wage. In other LAC countries, such as Chile (at the average wage), Argentina (1.07 times the average wage), Brazil (1.12 times the average wage), and Costa Rica (1.32 times the average wage) the threshold is also significantly lower than in Colombia. As a result, in 2018 more than 90% of the active population were exempt from the PIT and did not submit an end-of-the-year PIT declaration (OECD, 2019<sup>[4]</sup>).

**Figure 1.10 – Income threshold where single taxpayers start paying PIT (as a multiple of the average wage, 2018 or latest year available)**



Note: In Denmark, France and Turkey, PIT is levied on the first earned currency unit. For India, the average worker income covers only the manufacturing sector, including both men and women.

Source: OECD calculations based on the Taxing Wages models; OECD, Taxing Wages in Latin America and the Caribbean 2016; OECD, Taxing Wages 2019 (OECD, 2019<sup>[4]</sup>)

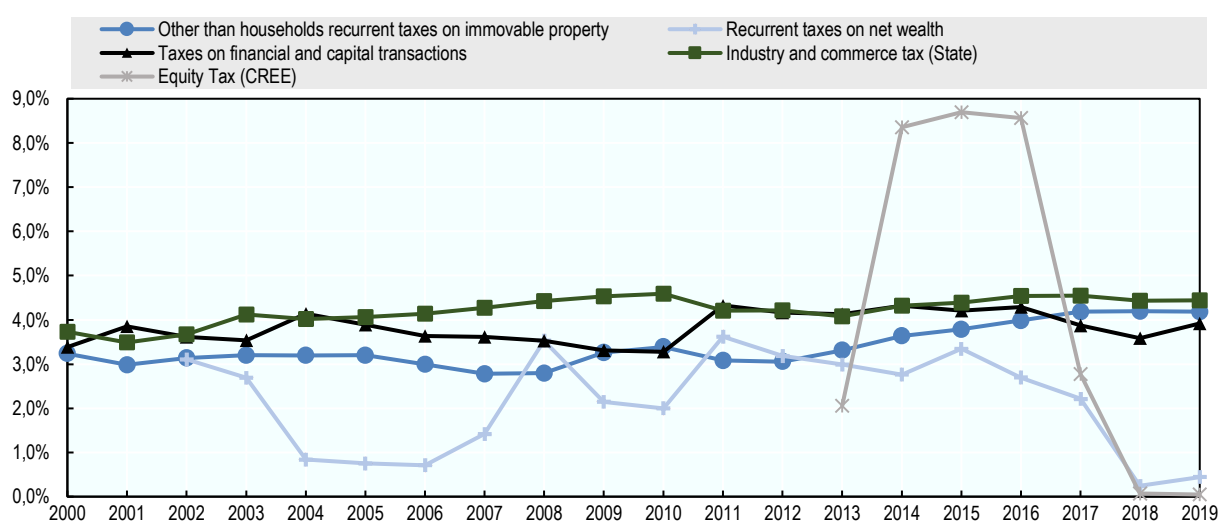
Colombia's tax mix also appears to be unique in its complexity. The tax mix consists of a large number of taxes that are, for the most part, atypical in the OECD due to their distortionary nature. Some of these are raised at the subnational level and contribute little to overall tax revenues. *Figure 1.11* shows the revenues (as a percentage of total tax revenues) raised from recurrent taxes on immovable business property, taxes on financial and capital transactions including the debit tax, the industry and commerce tax (ICA), as well as the equity tax (CREE) that was levied from 2103 to 2017. Colombia also levies VAT on investment in fixed assets, but no separate revenue information is available for that item.

The recurrent tax on business property is a municipal tax levied on the ownership of land or businesses' immovable property. Many OECD countries levy recurrent taxes on immovable property owned by businesses. While similar taxes that impose a burden on businesses irrespective of the profits earned are often criticised as discouraging investment, there may be a rationale to levy such a tax insofar as it is similar to a fee for local public service provision that the business benefits from, such as waste disposal and fire brigade services. The tax rate is set by the municipality and is applied to the self-assessed value of the property, rather than a market valuation. The share of revenues collected from recurrent taxes on business property is low, but increased from 3.1% in 2012 to 4.2% in 2019 (*Figure 1.11*).

The debit tax is a financial transitions tax and is included in the share of revenues from taxes on financial and capital transactions in *Figure 1.11*. In 2019, taxes on financial and capital transactions accounted for 3.9% of total tax revenues. The debit tax is levied at a rate of 0.4% on the amount of each financial transaction including, for example, the deposits and disposals of funds from savings accounts, current bank accounts and deposit accounts. Half of the debit tax liability is deductible from taxable corporate profits.

The Colombian municipal industry and commerce tax (ICA) is levied on business turnover. The tax has consistently raised between 4.1% and 4.6% of the total tax revenues (*Figure 1.11*). Taxpayers can deduct 100% of the tax paid from the CIT base or 50% from the CIT liability (as of 2022 the tax credit will increase to 100%). The rates are set by the municipalities and vary between 0.2 and 1%.

**Figure 1.11 – The share of revenues from less common taxes (as a % of total revenues)**



Source: OECD Global Revenue Statistics Database (OECD et al., 2020<sup>[7]</sup>)

Colombia has also attempted to raise revenues from an equity tax (CREE) in the past. The CREE was a mandatory alternative tax on corporate profits introduced in 2013 and phased out in 2016. From 2014 to 2016, the CREE raised between 8.4% and 8.7% of total tax revenues each year.

Colombia is also among the few countries in the OECD that levy a recurrent tax on net wealth. The tax was first introduced in 2002 and initially applied to corporations and individuals. In 2018, however, Colombia abolished the wealth tax on corporations except for non-resident businesses that are not subject to file an income tax return in Colombia; these businesses pay a tax of 1% on the value of the assets they possess in Colombia. The tax is also levied on individuals with net liquid assets greater than COP 5 thousand million COP (approximately USD 1.3 million) at a flat rate of 1% on their total net worth. Up to COP 472 million (approximately USD 128 000) of the value of the individual's residential property can be deducted from the net wealth tax base. The tax generated approximately 0.1% of GDP in revenue in 2019, a notable fall from 2.2% in 2017 (see *Figure 1.11*). The wealth tax was always temporary in nature and originally designed to last for only four years. However, the tax was extended and if it remains unaltered, will remain in place until 2021.

The tax burden on labour in Colombia is comparatively low. One measure of the taxation of labour is the tax wedge<sup>3</sup>, a measure of the difference between labour costs to the employer and the corresponding net

<sup>3</sup> The tax wedge is calculated by expressing the sum of personal income tax, employee plus employer social security contributions together with any payroll tax, minus benefits as a percentage of labour costs.

take-home pay of the employee. The tax wedge for single taxpayers earning the average wage (i.e. the wage that, on average, can be earned in the private sector in Colombia) is 0%, which is the lowest tax wedge in the OECD. However, this measure only includes payments that are classified as taxes (including social security contributions that fit the definition of taxes). Employees and employers in Colombia have to make non-tax-compulsory payments (NTCPs<sup>4</sup>), which include compulsory health and pension payments to private sector funds. These NTCPs increase the tax burden on labour income in a similar way to taxes. Colombian employers pay health, pension and occupational hazards contributions of 8.5%, 12% and 0.5 to 6.7% respectively. Employees in Colombia pay health and pension contributions of 4% each. The base of these SSCs is the monthly salary, limited to a maximum of 25 times the monthly minimum wage.

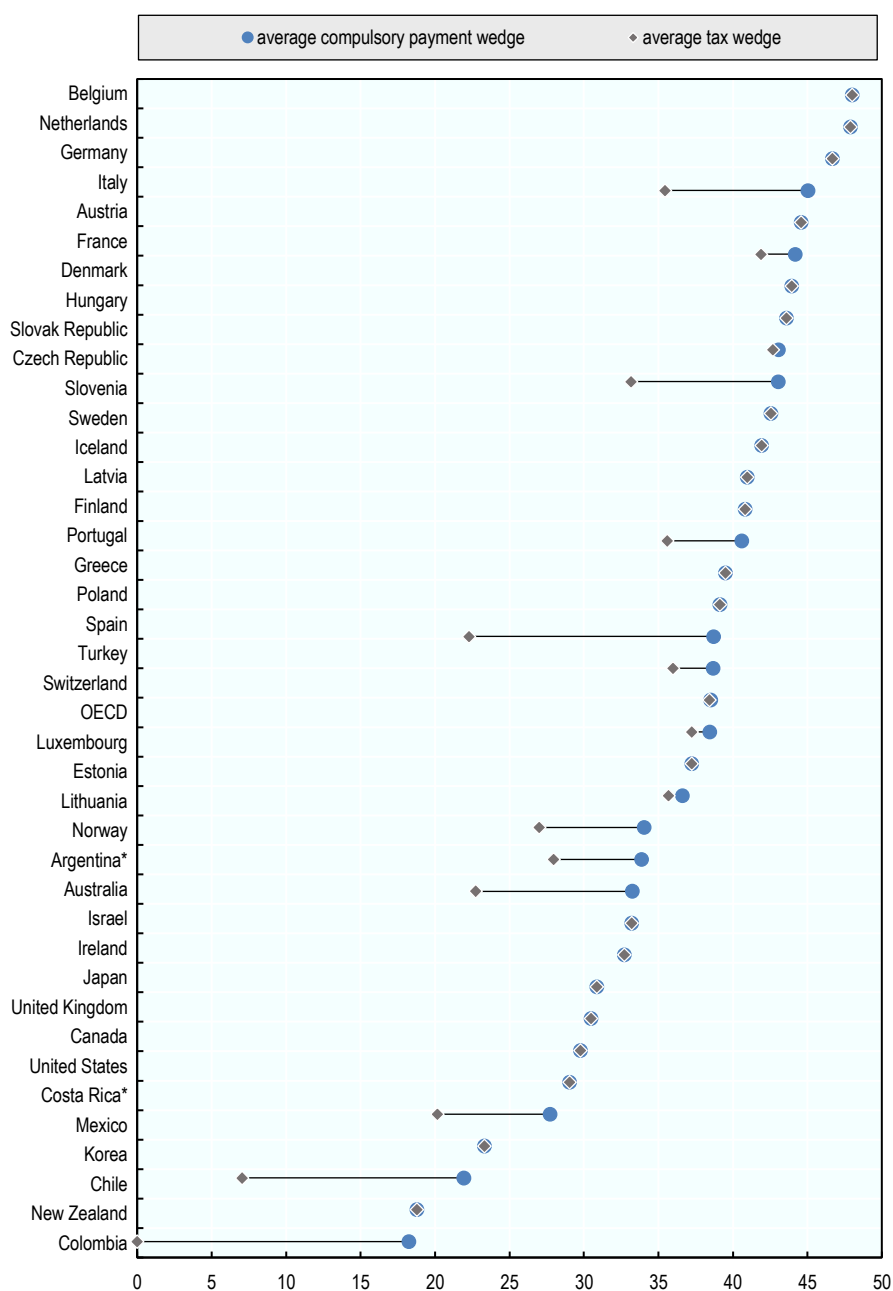
*Figure 1.12*, therefore compares average compulsory payment wedges and average tax wedges for single taxpayers at average earnings without children in 2019. Consequently, while the average tax wedge for single taxpayers earning the average wage without children is 0% in Colombia, the average compulsory payment wedge is significantly higher at 18.2%. The impact of NTCPs on average wedges is also significant in Switzerland (+16.4 percentage points) and Chile (+ 14.9 percentage points), for example. However, even when NTCPs are accounted for, Colombia's average compulsory payment wedge is the lowest among OECD countries. Argentina and Costa Rica are also included in *Figure 1.12* and both have higher average compulsory payment wedges of 33.0% and 29.0% respectively. Mexico too has a higher average compulsory payment wedge of 17.7%.

The labour income tax burden in Colombia is flat up to earnings just above three times the average wage where taxpayers start paying PIT. *Figure 1.13* presents average compulsory payment wedges and net personal average compulsory payment rates for single taxpayers without children and for those with two children (single parents), as well as for one-earner married couples with and without two children at varying income levels up to 2.5 times the average wage. While the average compulsory payment wedge takes into account the payments made by the employer and the employee, the net personal average compulsory payment rate only takes into account the taxes and non-tax compulsory payments made by the employee. The overall burden in Colombia remains relatively low and is the same across income levels as no PIT has to be paid at these earning levels, except for the impact of the child cash transfer that reduces the net amount of payments that taxpayers with children have to make. These results are confirmed in *Figure 1.14* that presents marginal compulsory payment wedges and net personal marginal compulsory payment rates for the four family types across income levels expressed as a multiple of the average wage. The marginal rates are flat except for the NTCP threshold levels at which taxpayers see an increase in the NTCPs they have to pay.

**Figure 1.12 – Average compulsory payment wedge and average tax wedge (for single taxpayers without children at average earnings), 2019**

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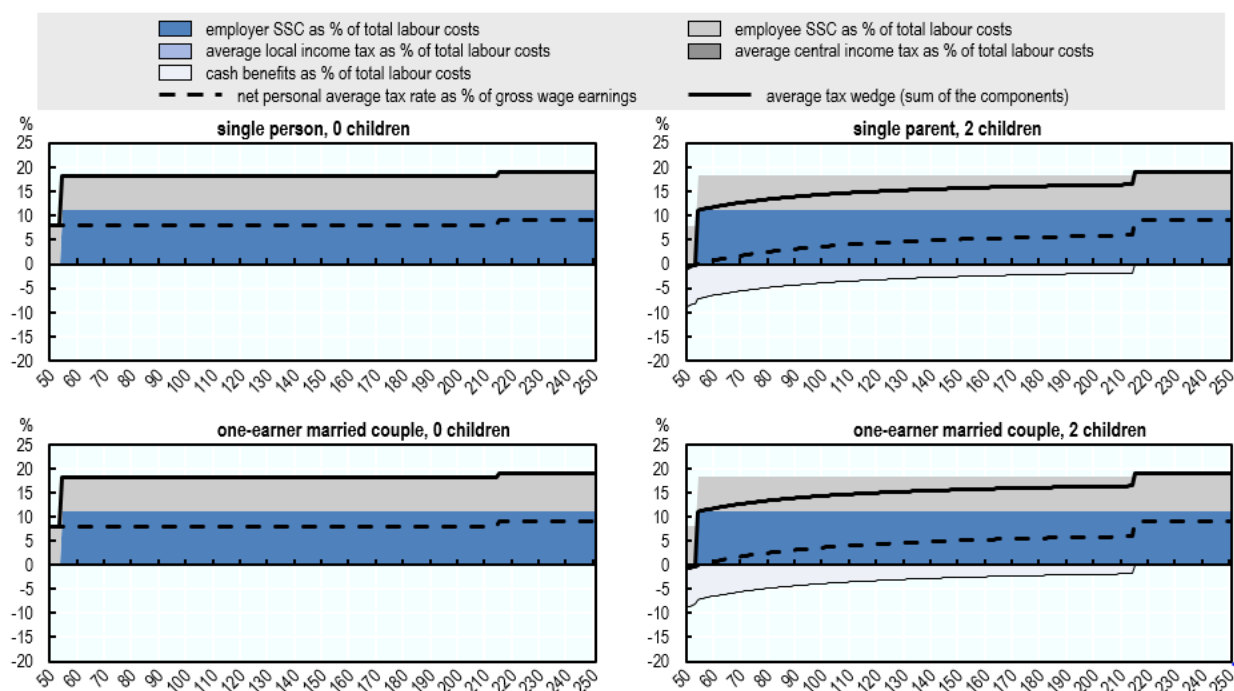
<sup>4</sup> A number of the SSCs in Colombia do not fit the OECD definition of a tax and are instead considered non-tax compulsory payments (NTCPs). Taxes are defined as compulsory unrequited payments to general government. NTCPs are compulsory payments not paid to general government but to private funds instead.



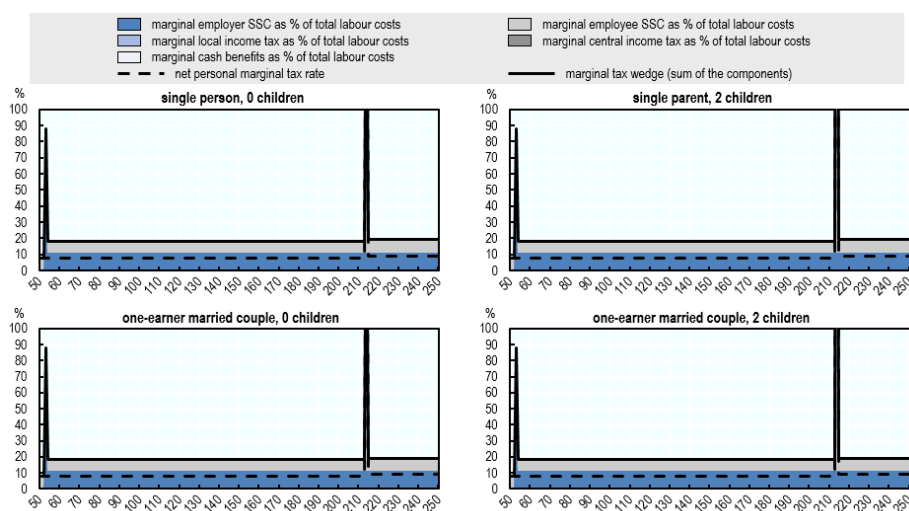
Notes: Countries are ranked by decreasing average compulsory payment wedge. Excludes the effect of work-related private insurance to cover accidents and occupational diseases. Data for Colombia are from 2020 and the rest is from 2019.

Source: OECD taxing wages database

**Figure 1.13 – Average compulsory payment wedges and net personal average compulsory payment rates (and decomposition) for different family types at varying income levels, by level of gross earnings expressed as a multiple of the average wage, 2019**



**Figure 1.14 – Marginal compulsory payment wedges and net personal marginal compulsory payment rates (and decomposition) for different family types at varying income levels, by level of gross earnings expressed as a multiple of the average wage, 2019**

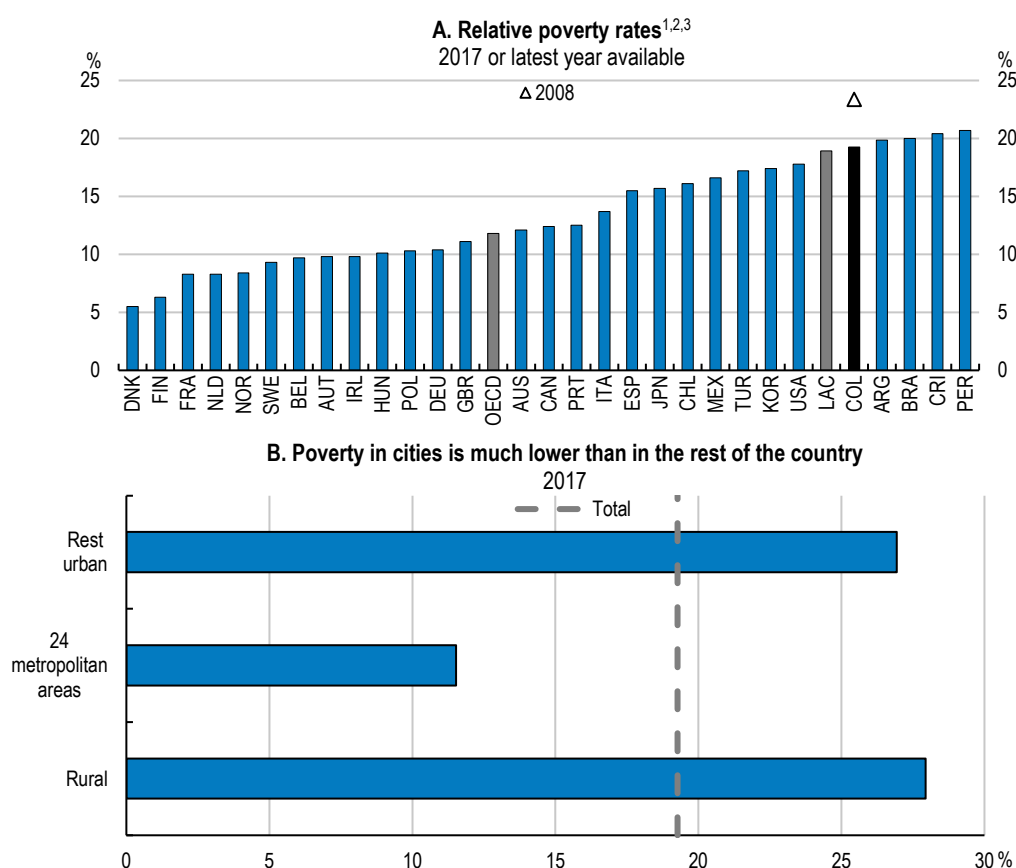


### 3. Distributional impact of the tax and transfer system

The implications of COVID-19 will put the notable improvements made in key social indicators at risk. In particular, poverty had declined significantly between 2008 and 2017 (see *Figure 1.15*). Government interventions may limit the virus' repercussions, but there has been concern that it could widen already

large regional disparities (OECD, 2014<sup>[8]</sup>) and reverse the pre-recession trend of declining income inequality (from a high level<sup>5</sup>) (World Bank, 2018<sup>[9]</sup>). Any widening of this gap between urban and rural areas will fall hardest on ethnic minorities and people displaced by former conflicts, who are disproportionately concentrated in rural areas, as well as on women who tend to be employed in more precarious forms of work (OECD, 2019<sup>[4]</sup>).

**Figure 1.15 – Poverty has declined, but territorial disparities remain large**



Notes: 1. Relative poverty rates after taxes and transfers (threshold of 50% of the median income). The statistical definition is different from the one followed by DANE. 2. OECD refers to the unweighted average of its member countries. 3. LAC refers to the unweighted average of Argentina, Brazil, Chile, Costa Rica, Mexico and Peru.

Source: OECD calculations based on GEIH Household Survey 2017, OECD Income Distribution and Poverty database and SEDLAC.

**Colombia's tax and transfer system has had a very limited impact on reducing inequality** (OECD, 2019<sup>[4]</sup>).

Despite some improvements following fiscal reforms over the last decades, income inequality remains high after taxes have been collected and benefits distributed to citizens (*Figure 1.16*). In Colombia, the Gini coefficient in 2017 was 0.48 both before, and after, taxes and transfers. For comparison, the OECD average Gini coefficient in 2017 was 0.42 before taxes and transfers, and 0.32 after. While redistribution is generally found to be higher in countries with higher market (before tax and transfer) income inequality, Colombia

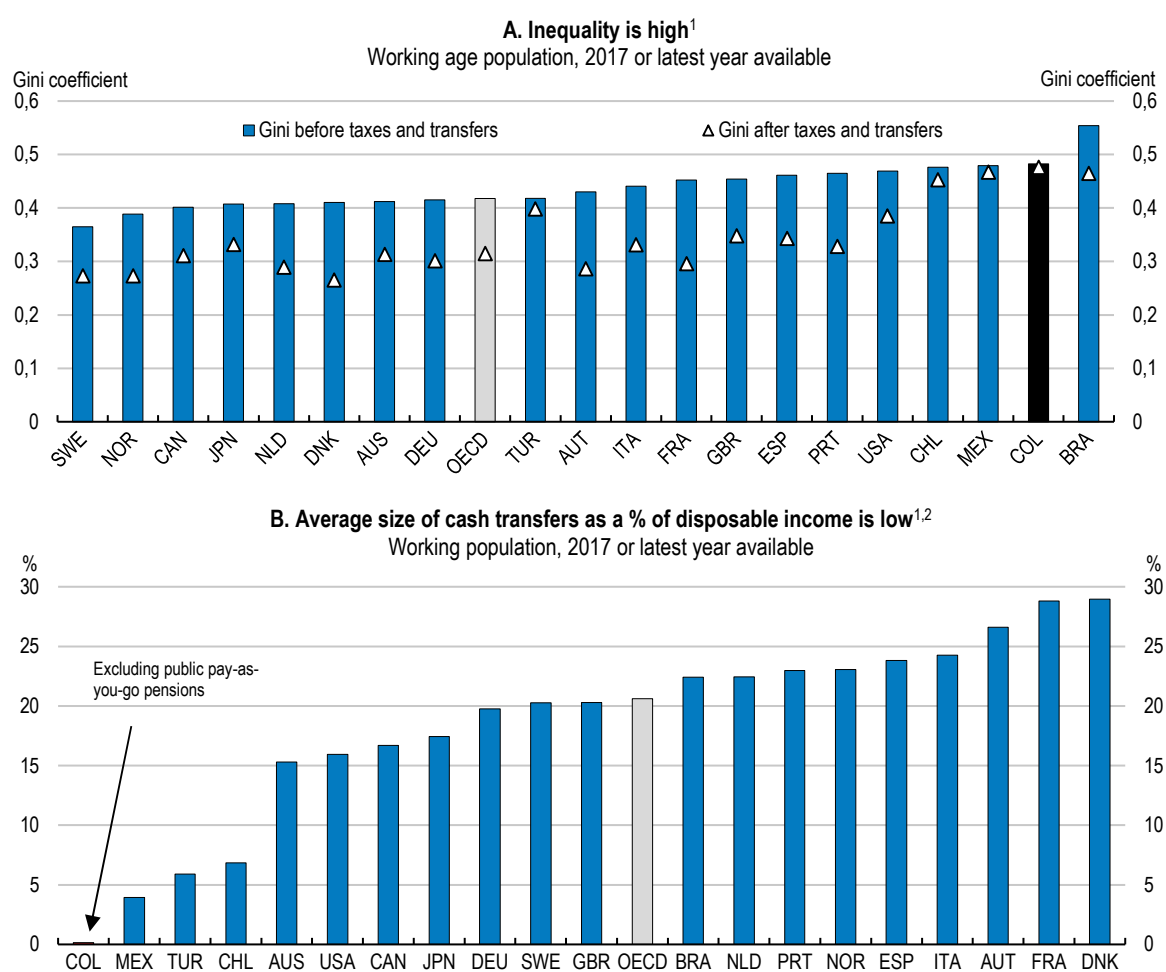
<sup>5</sup> OECD estimates suggest that it could take eleven generations for children of poor families to reach the average income in Colombia, compared to five generations across other OECD countries on average (OECD, 2018<sup>[14]</sup>).



has both high market income inequality and a comparatively low degree of income redistribution (Lustig, 2016<sup>[10]</sup>).

**The impact of the tax and transfer taxes may be limited for a number of reasons.** The progressivity of both income and wealth taxes is low, in part because of widespread tax expenditures and exemptions that disproportionately favour households with higher incomes and greater wealth, and the very limited size of transfers compared to both other LAC countries (26 times smaller than in Mexico) and the OECD average (137 times smaller) (Figure 1.16 Panel B).

**Figure 1.16 – Higher cash transfers focused on most needy regions would reduce inequality**



Notes: 1. OECD refers to the unweighted average of all its member countries. 2. Cash transfers excluding pensions from the pension system for Colombia (in the pay-as-you-go system and special regimes, and Colombia Mayor) and refer to Mas Familias en Acción, Jóvenes en Acción, Bienestar Familiar from ICBF, subsidies for displaced.

Source: OECD calculations based on GEIH Household Survey (2017) and the OECD Income Distribution and Poverty database.

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# Tax Expenditure Reporting in Colombia

Tax Expenditures Report



## 2 Tax Expenditure Reporting in Colombia

*Colombia currently publishes a brief annual tax expenditures (TE) report as part of the Marco Fiscal de Mediano Plazo annual report and a working paper that expands the analysis on corporate income tax expenditures. Colombia should seek to develop a stand-alone, annual TE report, which identifies the cost of all TEs, as is common practice in other OECD countries for strengthening fiscal management. A key issue for any TE analysis is to determine the reference point, or “benchmark” tax system, relative to which the nature and extent of any tax concession can be established. Currently, Colombia does not specify such a benchmark, which has resulted in an inconsistent list of TEs. Furthermore, the TIC has highlighted significant scope for improving the methodology used to estimate tax revenue foregone during its analysis. Discussions with the OECD have helped to refine the methodology employed to estimate revenue foregone from VAT exclusions and this has resulted in a significant decrease in these estimates. The analysis has also identified significant scope to improve the PIT and CIT TE estimations. The resources for the TE reporting and estimation unit within DIAN should be increased considerably. This unit should have the ambition to publish a comprehensive TE report that lists all TEs and presents tax revenue foregone estimates of most TEs on an item-by-item basis. The TE report should also include a sectoral analysis as well as a distributional analysis of the main TEs in order to increase the transparency of what the tax expenditure concessions are in Colombia.*

### 2.1 Introducing the concept of “Tax Expenditures”

Tax expenditures (hereafter TEs) are provisions in the tax legislation that modify the tax liability of specific groups of individuals or businesses. They are used by governments around the world to help achieve a wide range of economic, social and equity objectives, or to simplify the tax system. TEs are deviations from a benchmark tax system, under which such specific provisions are absent, and may take the form of tax exemptions, allowances, credits, reduced rates or tax deferrals.<sup>2</sup> TEs might have significant budgetary costs, however, which makes it important that they are estimated on a regular basis. In this way, TE reports contribute to fiscal transparency, the accountability of government, and support informed decision making on the allocation of public resources.

The term tax “expenditure” arises from the fact that they are equivalent to public expenditure implemented through the tax system. Despite the equivalence, TEs can be preferable to direct expenditures under certain circumstances, for example, when the tax administration has a comparative advantage in terms of administrative economies of scale and the capability of verifying data. Indeed, as TEs consist of a reduction of tax that would otherwise be paid directly, providing tax relief may be administratively less costly than developing and delivering new spending programmes. For this reason, TEs have a comparative advantage when the priority is to maximize the number of eligible individuals or businesses or when eligibility criteria is linked to data already reported on tax returns (Toder, 2000). On the other hand, TEs are less likely to fall under scrutiny than direct spending programmes, which might also explain why they are widely used. Measuring TEs therefore allows for a complete view of public expenditure (CIAT, 2011).

TEs often come at a significant tax revenue cost and should therefore be evaluated in the same way as direct expenditures. Like direct expenditures, TEs affect the allocation of governments’ limited resources and thereby entail an opportunity cost that implies that other taxes have to be higher than they otherwise would be. TEs should therefore be assessed in order to determine whether they achieve their objectives in a cost-effective and fair manner.

In principle, TEs are justified if their social benefits exceed their associated social costs. In the case of investment tax incentives, for instance, social benefits would typically involve net increases in investment,

employment or wages as well as productivity spillovers. Social costs would include net public revenue losses, administrative and compliance costs as well as distorted resource allocation among other costs (IMF et al., 2015a). Moreover, TEs may open opportunities for tax avoidance and evasion, and might lower both horizontal and vertical equity.

Evaluating whether TEs pass the cost-benefit test will inform decision-makers on whether they are desirable policy – as should be the case with other forms of public spending. As this exercise is demanding in terms of data needs, it should primarily be implemented for large TEs. When assessing the welfare implications of changes in government revenue (e.g. the increases in tax rates that are necessary to compensate for the introduction of the TE), the analysis should also take into account that a public dollar is worth more than a private dollar, i.e. the marginal cost of public funds is generally larger than one. This could be because the taxes required to generate public revenue are distortionary and/or because there are administrative and compliance costs related to revenue mobilization (IMF et al., 2015b).

TEs may also raise distributional concerns. Some TEs aim to steer the distributional effect of taxation, such as exemptions that target households most in need. However, other TEs that aim at different objectives can have important distributional implications as well. In fact, richer individuals tend to benefit more from some TEs than poorer individuals do. This is partly because tax reliefs are frequently granted in the form of allowances, the value of which increases with the taxpayer's marginal tax rate. Moreover, lower income households may not have sufficient taxable income to benefit from specific tax provisions. In other words, the take-up rate of TEs will vary across the income distribution. For example, higher income households tend to benefit more from mortgage interest deduction because they have both larger mortgages and higher marginal tax rates (Poterba and Sinai, 2008). Similarly, in the absence of limits on the amount of relief available, taxpayers with higher incomes benefit relatively more from the preferential tax treatment of retirement savings (Brys et al., 2016).

## 2.2 Defining a Tax Expenditure Benchmark

A key issue for any TE analysis is to determine the reference point or so-called “benchmark” tax system against which to establish the nature and extent of any tax concession. Once a benchmark tax system has been defined, the TEs are identified in a relatively straightforward manner, namely as those tax provisions that deviate from the benchmark. However, benchmarks are defined differently both across countries and often even within countries over time. Therefore, TE estimates are usually not directly comparable across countries or years. Ultimately, the choice of the benchmark and the TEs that follow from it should be guided by the purpose for its users.

A benchmark tax system is typically defined using one, or some combination, of the following three approaches:

- **Conceptual approach.** This approach defines a normative benchmark tax system based on an ‘external’ or theoretical concept of comprehensive income or consumption that provides guidance on how tax policy should be defined, irrespective of whether this benchmark accurately reflects existing tax law. Under this approach, the benchmark tax base could be defined as a comprehensive income tax base or a broad-based consumption tax base (see Annex).
- **Reference tax law approach.** Under this ‘internal’ approach, a country’s existing tax system forms the starting point for defining the benchmark. A TE is an explicit concession that departs from what is considered a generally applicable tax provision under the existing tax law. This approach provides more flexibility in defining TEs and will generally provide a narrower list of TEs than the conceptual approach.

- **Expenditure subsidy approach.** This approach seeks to cost only those concessions that are clearly comparable to an expenditure subsidy. This method is rarely used in practice and it would likely result in a narrower list of TEs than under the other two approaches.

Combinations of these approaches are possible. A hybrid approach would take a conceptual benchmark as the starting point, but modify it by taking into account certain structural features of the actual tax system of a country. Compared to the conceptual approach, a hybrid can be more pragmatic by incorporating certain constraints within the benchmark, for instance, tax elements that would be difficult to implement in a theoretically pure benchmark system.

The choice of the benchmark (and the TEs that follow from that benchmark) requires some judgement and should be guided by the purpose of the TE reporting for its users. A conceptual approach provides more normative guidance to the user if there is a common view about the most desirable tax system. This can facilitate a transparent discussion on how existing tax provisions reduce revenue compared to that norm. However, even if a conceptual benchmark is chosen, this should not necessarily be interpreted as an indication of the way taxpayers should be taxed. Indeed, the reference law approach might be a reflection of what society views as a desirable system, and TEs are indicative of the revenue foregone from special provisions relative to that system. This would also provide a better sense to policy makers about the revenue impact of eliminating such provisions, as its reference is the existing tax system, rather than some theoretical concept that may deviate from that in various ways.

The choice of the benchmark tax system should thus be linked to the objective of the TE report that policy makers have in mind. In general, most policy makers intend to use a TE report as an input into the evaluation of TEs to put them under the same scrutiny as ordinary public expenditures in terms of revenue costs, efficiency, effectiveness and equity, as well as transparency and fiscal accountability. While it might have some appeal to define a benchmark that follows a well-established conceptual tax system as closely as possible, if the implementation of this benchmark is not feasible within the current tax architecture, the arguments to apply that ideal as the TE benchmark are weakened. Incorporating elements of the reference tax law is therefore a common approach in TE assessments across the OECD.

Given the importance of the benchmark tax system for TE analysis, the following criteria can guide its choice:

- **Well-defined and transparent.** The benchmark should be well-defined and transparent so that policymakers and the public at large understand the underlying assumptions that have been made and they can verify the calculations.
- **No discrimination.** The benchmark should represent the standard taxation treatment that applies to similar taxpayers or types of activity (reflecting horizontal equity). Discriminatory elements in the tax code will be qualified as TEs. This does not apply to the progressive structure of the personal income tax, which typically is included as part of the benchmark (to support vertical equity).
- **Avoid negative TEs.** Tax provisions that increase the tax burden do not constitute a tax reduction (i.e. an “expenditure”) but rather result in a tax increase. TE assessments should try to avoid negative TEs as much as possible, by making these provisions part of the benchmark. However, there might be cases where negative TEs are informative. For instance, this can be the case if the government disallows certain deductions that would be common in a benchmark tax system.
- **Consistent.** The benchmark should be consistent across taxes and make explicit reference to how it treats measures that relieve double taxation (integration). For example, if there is integration of corporate and personal taxation, the benchmark system should be consistently applied to both the assessment of TEs in the CIT and in the PIT.

- **Actionable.** The benchmark should be defined in a way that the resulting list of TEs informs policy makers about possible reform options. At least, the TE list provides a starting point for an evaluation of tax concessions.
- **Facilitate international comparability.** The benchmark may be chosen such that it follows the approaches in other countries, although these may vary in various dimensions and details. By using a similar benchmark used elsewhere, the TEs might be compared with those other countries, although caution remains important in doing so.

Reconciling these different criteria in choosing an appropriate benchmark system involves an element of judgment. For instance, following a conceptual approach can be most clear and transparent, but might not produce actionable TEs. The ultimate choice of the benchmark should depend on the main purpose of the TE reporting for the users. However, what is crucial is that countries define a TE benchmark to ensure that TEs are identified, listed and measured in a consistent manner.

## 2.3 Measuring Tax Expenditures

Once a benchmark has been specified, different methods can be applied to measure TEs. TEs are distinct from standard expenditures since the amounts “spent” are notional as their estimated value is based on assumptions and estimates as to how taxpayers would behave under particular conditions. Ideally, TE calculations are made using administrative tax return data, which is preferred over other data sources such as survey data. Nevertheless, other data sources can complement tax administrative tax return data in certain cases.

There are three main methods for measuring TEs:

### 1. Tax Revenue Forgone

This method quantifies the direct ex-post revenue loss associated with the provision relative to the benchmark system (holding other factors constant). For this reason, it is the most common and straightforward estimation method. The method calculates the tax liability the taxpayer would face in the absence of the particular TE and subtracts the taxpayer’s tax liability in the presence of the TE; the difference is the tax revenue foregone from the TE. This method has the following characteristics:

- *No dynamic tax effects.* The method provides a static calculation that does not capture changes in behaviour that the provision induces. Therefore, the TE estimate may differ from the expected revenue effect from the removal of the specific provision. For instance, if a tax relief for one specific type of saving (a tax provision that yields a TE) is withdrawn, individuals may switch to other tax-privileged forms of saving. The TE estimate can then differ from the revenue effect from removing the specific relief measure.
- *No interdependence.* A TE estimate for one provision is typically based on the assumption that other TE provisions remain intact and that their value is not recalculated when one TE is taken away. Hence, each TE is estimated in isolation; that is without taking into account interaction effects between different TEs or between the TE and the tax system in general. However, in practice the removal of one TE may alter the revenue foregone from other TEs. For instance, the removal of a TE may increase taxable income and the marginal tax rate the taxpayer faces, thereby increasing the revenue foregone of other TEs. Thus, under the revenue foregone method, individual TE estimates cannot be aggregated to arrive at an estimate of the overall revenue consequences if all TEs were simultaneously removed.
- *Dependent on take up.* Revenue foregone estimates are based on the actual take up of a relief (under the assumption that TE calculations are made using administrative tax return data).

- *Constant compliance and enforcement.* TE estimates assume that tax compliance and enforcement efforts remain constant at their current level. However, taxpayers could become more or less aggressive in their tax evasion strategies upon the removal of a TE. Removal of TEs can also simplify the tax system and facilitate enforcement.

## 2. Tax Revenue Gain

This method provides an ex-ante estimate of the additional revenue that would take place from eliminating a given TE when behavioural responses are taken into account. This method would provide a more comprehensive estimation than that of the revenue forgone method, but for this reason requires a good understanding of taxpayers' behaviour and data on elasticities that are not always available and/or reliable.

## 3. Outlay equivalent method

This method estimates TEs associated with a given provision as the expenditure that would be required if the subsidy was provided outside the tax system. The main difference is that the outlay equivalent method does not take into account the other factors that determine the actual tax liability that an agent faces.

The value of TEs cannot be adequately compared across countries, even when they use the same method. International comparability of TE estimates is especially problematic due to the differences in definition of the benchmark tax system. Furthermore, countries also vary in the coverage of taxes in TE reports. For instance, while some countries report TE estimates for all levels of governments, others only report those related to central government. In addition, as many tax provisions are formulated as tax allowances, the value of tax expenditures typically depends on the level of the marginal tax rates. Hence, TE values across countries may also differ because of differences in statutory tax rates rather than differences in the number and extent of provisions. The value of TEs will also vary with the take-up of a specific tax provision, which may vary across countries for reasons outside of the tax system. For these reasons, international comparisons of TE values should be avoided. While TE values cannot be compared across countries, this does not apply to TE methodologies and the TE benchmarks that are chosen. Here, comparing country practices can be useful for peer learning and guide choices for countries' methodology.

## 2.4 Tax Expenditure Reporting

The main goal of TE reports is to increase transparency and accountability and, in this way, contribute to well-informed choices on allocation of resources. Increased transparency through TE reporting can improve fiscal governance and help reduce the scope for rent seeking. TE reports also provide information for cost-benefit assessment and thus contribute to well-informed decision making. Indeed, TE reports are a useful starting point when considering the advantages and disadvantages of broadening tax bases by reducing or removing tax reliefs. TE analysis can also facilitate distributional analysis, i.e. an analysis of the allocation of tax relief across different taxpayer groups, which can help to improve the fairness of the tax system.

Best practices in TE reporting include:

- **Publication of TE reports should be integrated into the budgetary process compulsory by law.** Bringing TEs into the budgetary process should increase transparency by subjecting them to a similar level of scrutiny as direct expenditures (Polackova et al., 2004).
- **Reporting should ideally be on an annual basis**, which is practice in most countries.
- **The benchmark should be clearly defined and documented.** The report should include a clear description of the benchmark tax system. Ideally, the TE report (or an accompanying



methodological annex or background document) should include a discussion and justification for the choice of that benchmark.

- **The TE estimation method should be described in detail on an item-by-item basis within the TE report**, either as part of the main body of the report or as an annex within the report. This will provide transparency and clarity to the reader of the underlying calculations and TE estimates.
- **TE reports should classify provisions along different dimensions.** Ideally, TEs should be classified by type of tax (PIT, CIT, VAT, excise taxes, etc.), type of TE (credit, allowance, exemption, reduced rate), the function to which they are attributable (education, fuel and energy, health, defence, etc.), their policy objective (employment, R&D and innovation, housing, reducing poverty, etc.) as well as the targeted beneficiary group (corporations, individuals, SMEs, self-employed, etc.). If TEs vary across sectors and industries, it would be useful to list all the TEs that specific industries can benefit from in order to increase transparency.
- **Including the legal reference for each TE** is good practice for clarity and transparency.
- Despite having significant drawbacks, the total sum of all **TEs expressed as a share of GDP and/or as a percentage of total tax revenues** might be included. As indicated before, summing up TEs can be misleading as it ignores the joint impact on the revenue foregone from the various interactions between provisions. While the sum of TEs can thus not be interpreted as a revenue loss, it does provide an indication of the overall magnitude of TEs in the country's tax system, which can be reviewed over time. Indeed, the development of the sum of TEs in a given country can be informative if the benchmark is kept the same for a number of years. However, readers of the TE report should be warned of the limitations of this overall estimate, as pointed out above. Countries differ in their approach; for instance, Australia, Canada, Italy and the United States do not include an overall TE figure in their TE report, but other countries such as France do.
- **Ranking all TEs by their value** or otherwise list the top TEs can improve clarity and guide users to the main provisions in terms of revenue foregone.
- **All TEs should be listed.** The cost of certain TEs may not be reported because of lack of data or disproportionate estimation costs among other factors (Redonda and Neubig, 2018). TE reports should nonetheless list all TEs identified, irrespective of whether they are measured or not.
- **Provide information, if possible, on the distributional impact of TEs.** A distributional incidence analysis of the TEs (including take-up rate and value of the TE across the income distribution) will inform decision makers on a different aspect that is important for assessing its benefits.
- **Assessment of the reliability of estimates.** Grading the estimation reliability of each TE estimate can help the reader better interpret the figures. A possible grading would be "high", "medium-high", "medium-low", "low".

There is no unique format across countries for TE reports. Redonda and Neubig (2018) identify nine countries that publish a detailed and comprehensive TE report, namely: Australia, Austria, Canada, France, Germany, Italy, Netherlands, Korea and Sweden.

## 2.5 TE Reporting and Measurement in Colombia

The publication of a report that provides information on the forgone revenue associated to TEs has been required by law in Colombia since 2002. Limited TE estimates are provided as part of its annual report

*Marco Fiscal de Mediano Plazo* (MFMP) published by the Ministry of Finance, while DIAN produces an annual working paper that describes CIT TEs in more depth.

**Table 2.1 assesses the Colombian TE report as compared to best international practices.**

**Table 2.1 Assessment of the Colombian TE report as compared to best practices**

Best practice TE reporting	Practice in Colombia
Publication of TE reports integrated into the budgetary process compulsory by law	√
Reporting on annual basis	√
Report revenue forgone on an item-by item basis	
Clearly defined and documented benchmark	
Description of methodology used in TE estimates	(*)
Classify provisions along different dimensions	(*)
Include legal reference for each TE	
Sum of all TEs expressed as a share of GDP	√
Include an explanation that summing TEs is misleading and does not reflect an accurate measure of tax revenue foregone	
Rank all TEs by their value or list top TEs	
List all TEs	
Provide information on the distributional impact of TEs	
Assessment of the reliability of the estimates	

Note: √ signals the practices that the Colombian TE report follows. (\*) The separate working paper published by DIAN includes more detailed information on the methodology used to measure TEs and classifies TEs along economic sectors and types of taxpayers but only for CIT TEs.

The assessment in Table 2.1 shows that the TE reporting approach that Colombia follows does not meet good practice in most dimensions that have been identified in this chapter, including:

- Currently, discussions on TEs are included as an appendix of the MFMP report that discusses the macroeconomic setting of the country and its fiscal strategy. The appendix of MFMP report includes TE figures for a selection of taxes including the VAT, carbon tax and fuel excises (*Impuesto Nacional a la Gasolina and ACPM*). Revenue forgone estimates from income taxes (PIT and CIT) are included as an annex of the appendix. The TE analysis and discussion lacks transparency and does not provide adequate input for a tax policy discussion.<sup>6</sup> Furthermore, DIAN publishes an annual working paper that describes CIT TEs in more depth and provides corporate effective tax rate estimates. This working paper was

<sup>6</sup> The 2019 MFMP includes revenue forgone estimates for VAT, CIT and PIT TEs all together in the last chapter of the report rather than an Appendix and Annex of the Appendix.

notably more comprehensive from 2003 until 2011, as it previously also covered PIT and VAT TEs;

- Colombia follows a reference law approach (Avedaño et al., 2019). However, it has not explicitly defined many aspects of its TE benchmark. For example, how capital is taxed under the benchmark tax system and what is the tax treatment of pension and pension savings, etc;
- Revenue forgone from income taxes is not reported on an item-by-item basis but only based on large categories, due largely to the lack of detailed information in tax returns;
- The description of the TE measurement method applied is weak. Very little information is provided on how the tax revenue forgone was calculated except for CIT TEs that are described in a separate working paper;
- The lack of methodological rigour in the definition of the benchmark and of detailed information in tax returns results in imprecise estimates of CIT and PIT TEs;
- No full list of all TEs is included, and there is no reference to the legal tax article where the TE is defined;
- No distributional analysis is provided;
- Readers cannot get a clear picture on all the TEs that specific business sectors benefit from.

Revenue forgone reported in the MFMP report amounted to 8.7% of GDP in 2019 (see Table 2.2). However, the TIC's analysis indicates that VAT exclusions are overestimated (by more than 2 percentage points of GDP), while many income tax TEs are not currently adequately measured. This is discussed in more detail in the following sections of this chapter. Revised estimates of VAT exclusions imply that total TEs would amount to 6.5% of GDP. However, these figures should still be interpreted with caution, in particular because the revenue foregone of the CIT and the PIT are surprisingly low in light of the wide range of TEs that the TIC report has identified. The reason for the low income tax TEs remains unclear – they may be the result of measurement error, an estimation method that focuses on a small selection of TEs only (for example, TEs that take the form of non-taxable income are currently not measured), because tax returns do not allow for the adequate measurement, or the result of large-scale tax evasion. Even when considering adjusted revenue forgone estimates based on the OECD's recommendations, i.e. when non-market services, imputed rent from residential houses and illegal production are not considered in potential VAT computations, Colombia has the largest tax revenue forgone of all countries in Latin America and the Caribbean (see Figure 2.1).

**Table 2.2 Revenue forgone measured in the MFMP**

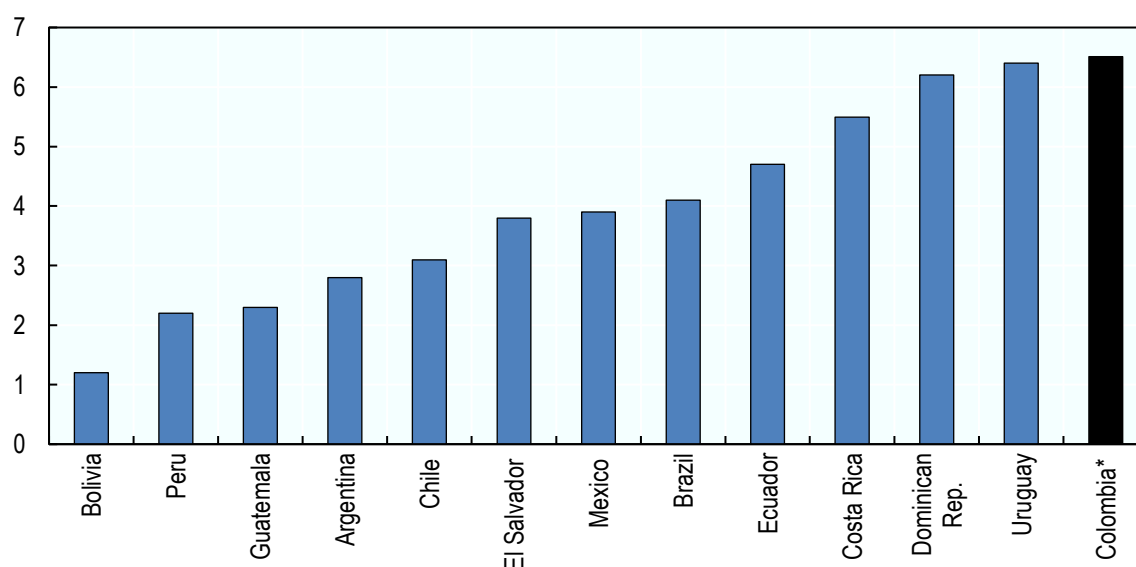
	COP thousand millions		% of GDP	
	2018	2019	2018	2019
<b>VAT</b>	<b>67 254</b>	<b>74 939</b>	<b>6.80%</b>	<b>7.10%</b>
Exclusions*	55 340	61 285	5.60%	5.80%
Exemptions	9 265	10 181	0.90%	1.00%
Reduced rates	2 649	3 474	0.30%	0.30%
<b>CIT</b>	<b>7 238</b>	<b>10 104</b>	<b>0.60%</b>	<b>0.90%</b>
Exempt income	4 359	4 188	0.40%	0.40%
Tax credits	1 049	4 533	0.10%	0.40%

Deduction investment in fixed assets	905	803	0.10%	0.10%
Reduced rates FTZs and certain stability contracts**	925	580		0.05%
<b>PIT</b>	<b>6 505</b>	<b>7 009</b>	<b>0.70%</b>	<b>0.70%</b>
Exempt income and tax allowances	6 083	6 554	0.60%	0.60%
Tax credits	422	455	0.00%	0.00%
<b>Fuel excises</b>	<b>203</b>	<b>228</b>	<b>0.00%</b>	<b>0.00%</b>
<b>Carbon tax</b>	<b>274</b>	<b>165</b>	<b>0.00%</b>	<b>0.02%</b>
<b>Total</b>	<b>81 474</b>	<b>92 445</b>	<b>8.1%</b>	<b>8.7%</b>

Source: MFMP 2020.

Notes: \*Following OECD requests, DIAN has adjusted the revenue forgone estimates for VAT exclusions. According to this revised estimate, revenue forgone from VAT exclusions amounted to 37 908 COP thousand million in 2019 (3.6% of GDP). \*\*Reduced rates for operators and users of FTZs are not reported separately in the MFMP annex of Appendix 1 but are included in the total CIT revenue forgone in Table AP1.1.

**Figure 2.1 Forgone revenue across LAC countries, as a percentage of GDP**



Source: CEPAL (2019) except for Colombia. Revenue forgone for Colombia refers to the data reported in MFMP 2020 with VAT exclusions adjusted in line with Table 2.4.

## 2.6 TEs in the Colombian VAT

To estimate the TEs within the VAT, DIAN uses national accounts input-output data. It corrects for the fact that a share of the transactions takes place in the informal sector through the use of an evasion factor, which is updated annually (this factor was estimated at 23.2% in 2019). Under the benchmark, the standard VAT rate (19%) is applied. The use of input-output national account data is aligned with standard practice.

The tax revenue foregone in Colombia of VAT TEs is large. The figures provided by the tax administration show a total TE of 7.1% of GDP in 2019 and VAT exclusions were estimated at 5.8% of GDP, exceeding other VAT concessions as well as TEs associated with other taxes (see Table 2.1). However, revenue forgone from VAT exclusions is substantially over-estimated, as is explained below.

### Measurement of forgone revenue from VAT exclusions

As of 2011, there was a significant broadening in the benchmark that was applied for measuring revenue forgone from VAT exclusions. Amongst the most important changes were the inclusion of non-market services – such as the provision of free education and health care, public administration services and social security benefits – imputed rent, and illegal drug consumption, within the VAT benchmark. This means that the VAT TEs include the VAT revenue foregone from these transactions. The inclusion of non-market transactions in the benchmark VAT (i.e. when computing potential VAT revenue from removing exclusions) is uncommon, and the rationale for this approach seems weak, in particular if Colombia is not planning to tax these transactions at market prices. Similarly, information on imputed rents from housing is included in national accounts, but these rents cannot be easily taxed by a VAT. As there is no transaction that takes place in the case of owner-occupied housing, including imputed rents in the VAT benchmark does not lead to an *actionable* TE (Hutton, 2017). Furthermore, VAT cannot be applied to the consumption of drugs because their consumption is illegal and, again, Colombia does not have plans to bring these transactions within its regular economy and tax these transactions under the VAT.

According to the MFMP (2020), the sectors that have the largest VAT TE exclusions are real estate services, public administration services and compulsory social security services, healthcare and education services. However, this ranking is heavily biased by the inclusion of imputed rent from residential housing and non-market services in potential revenue estimations.

Upon the OECD's request, DIAN has re-estimated the forgone revenue from VAT exclusions, removing non-market services, imputed rent and illegal consumption. The new estimates show VAT revenue foregone in the order of 3.6% of GDP, which is 2.2 percentage points of GDP lower than the VAT TEs that are published in the MFMP report. These revised criteria change the ranking of sectors that benefit the most from VAT exclusions, placing agricultural and horticultural products at the top of the list followed by financial and real estate services. Table 2.3 compares revenue forgone estimates published in the MFMP with the revised estimates.

**Table 2.3 VAT revenue forgone from excluded goods and services official estimates vs adjusted, 2019, COP thousand millions**

	Published in MFMP (2020)	Adjusted <sup>(i)</sup>
<b>Total</b>	<b>61 285</b>	<b>37 908</b>
Real estate services	9 432	3 711 <sup>(ii)</sup>
Public administration services and other services provided to the community at large; Mandatory social security benefits	9 364	0 <sup>(iii)</sup>
Human health care and social services	6 372	1 688 <sup>(iii)</sup>
Education services	6 221	2 984 <sup>(iii)</sup>
Agricultural and horticultural products	6 026	6 006 <sup>(iv)</sup>
Recreational, cultural and sports services	1 511	1 415 <sup>(iii)</sup>
Services from associations	254	0 <sup>(iii)</sup>
Other excluded goods and services	22 105	22 105 <sup>(v)</sup>
<b>Total (% of GDP)</b>	<b>5.8%</b>	<b>3.6%</b>

Notes: Excludes nonmarket services, imputed rent from residential houses and illegal production when computing potential VAT revenue when estimating potential revenue. (ii) Excludes potential VAT revenue from imputed rent for residential housing (CPC 720101 product code from national accounts input-output matrix). (iii) Excludes potential VAT revenue from non-market services. (iv) Excludes potential revenue from illegal consumption goods (CPC 011001: Coca leaf y CPC 011002: Poppy and marijuana). MFMP (2016) mentions that there is a code that quantifies cocaine and heroin production. These goods should also be excluded when calculating potential revenue. (v) DIAN measures potential VAT revenue from removing VAT exclusions and also applying VAT to the salaries paid to housekeeping services, which is uncommon.

Source: DIAN.

## Measurement of the VAT exemption for FTZs

Prior to 2020 FTZ businesses did not seem to collect all VAT from the goods sold to the domestic economy (and DIAN faced difficulties verifying the actual VAT due as FTZ businesses did not file a VAT return). Official figures from DIAN show that the tax revenue foregone from the VAT exemption for FTZs was valued at approximately COP 1 858 thousand million in 2019 (0.2% of GDP) mainly due to tax evasion. Ideally the TE measurement should measure revenue forgone associated to the exemption rather than other factors that lead to a decrease in revenues such as tax evasion. Since 2020, FTZ users must declare VAT collected on goods sold to the national territory. As a consequence, DIAN's revenue forgone estimates from the VAT exemption to FTZs users dropped significantly to COP 247 thousand million.

## 2.7 TEs in the Colombian CIT

The MFMP reports forgone CIT revenues of 0.9% of GDP in 2019 (see Table 2.2). However, this figure significantly under-estimates the total value of CIT TEs as it does not include information on the forgone revenue associated with non-taxable income and non-standard deductions, which in the view of this Commission are considered a TE, as well as reduced rates from specific regimes (see Chapter 3 for a more detailed discussion). This is due to both the absence of a clearly defined benchmark and the limited information available in tax returns.

According to the annual working paper on CIT forgone revenue, the tax provisions that are considered tax incentives are: accelerated depreciation (deduction for the investment of fixed assets), exempt income and tax credits (Avedaño et al., 2019). In fact, the MFMP states that non-taxable income and deductions are not TEs because "...their existence does not always imply a tax benefit for the taxpayer, given that there is not an improvement in the financial position" (MFMP, 2019, p. 492).<sup>7</sup> However, this interpretation is not aligned with the approach that all other OECD countries follow and that defines TEs as deviations from a well-defined tax benchmark. Indeed, some of these items have been identified as a TE in this report, such as the sale of shares of a company listed on the Colombian Stock Exchange, profits used to repurchase shares, and certificates for mining and hydrocarbon explorations. Furthermore, this estimate does not include information on the forgone revenue associated with reduced rates from specific business tax regimes, for example from hotels, ZOMAC and ZESE. Instead, the MFMP report measures exempt income from retirement savings in the financial sector (RAIS) as a TE. Given that Colombia's preferred benchmark for pension savings is an exempt-exempt-tax, this income should not be measured.

The analysis in this report calls for a strengthening of TE reporting and the measurement it uses. In order to increase transparency, Colombia should define a tax benchmark that can be used to decide whether CIT provisions can be considered as TEs or not. Non-taxable income and non-standard deductions in many cases lead to TEs and should therefore be measured. The standard CIT rate should continue to be used by DIAN as the benchmark rate, but there are many examples of the poor approach the MFMP currently follows. For instance, Table AP1.1 of the MFMP includes an estimate of FTZs' reduced rates in its total revenue forgone, but these estimations seems particularly low and the report does not provide any

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<sup>7</sup> Some members from DIAN disagree with this definition and argue that the reason why certain TEs that are non-taxable income are not measured is simply because of a lack of disaggregated information.

guidance on how to interpret these figures. In addition, revenue forgone from reduced rates from hotels and other specific business regimes is not included in the MFMP.

The simplification of business tax returns in Colombia do not allow for the identification of tax revenue forgone on an item-by-item basis. This weakness not only complicates the auditing function of DIAN but also prevents the calculation of tax revenue foregone for a wide range of CIT TEs. However, detailed information can be found in magnetic media reports that corporations submit to the Tax Administration at the same time they fill out their income tax returns. This data can be used to estimate revenue forgone for many CIT TEs, but a number of caveats must be acknowledged. First, they do not contain complete information on all TEs, and second, there continues to be a number of inconsistencies with tax returns. In the medium run, tax returns should be modified to allow for reporting TEs on an item-by-item basis.

According to both the MFMP (2020) and Avedaño et al. (2019), a more precise description of tax expenditures (and of the potential revenue gain of removing these TEs) is obtained by considering taxpayers exclusively, rather than all entities that file a tax return. That is, it is suggested that excluding entities in special regimes and entities that are not taxpayers (such as non-profit organisations) provides a better picture of TEs. The argument DIAN provides is that these entities would not carry out their activities in the absence of TEs and therefore more public expenditure would be needed. This line of reasoning is inconsistent. It is of paramount importance that the TE report provides a detailed analysis of all TEs provided to all entities. Otherwise, it can lead to misleading conclusions. Furthermore, as was explained previously in this chapter, revenue forgone measures cannot be interpreted as revenue gain estimates as they do not take into account behavioural effects. Exempt income estimates should always include entities that are not taxpayers such as non-profit organisations.

## 2.8 TEs in the Colombian PIT

The tax revenue foregone estimates for the TEs in the PIT, which are included in the MFMP, present difficulties as the figures for the CIT. The individual tax returns include a single cell where taxpayers report all deductions and exempt income with respect to labour and capital income. This highly aggregated reporting approach does not allow the calculation of PIT TEs on an item-by-item basis. Instead, an aggregated estimate is reported in the MFMP. Furthermore, any TE that is currently considered non-taxable income is not measured. As Chapter 5 indicates, many non-taxable income items are considered TEs and should be measured (if not reformed). These non-taxable income items include voluntary contributions to RAIS, military, police and judge and prosecutor salaries, fringe benefits, sale of shares of a company listed on the Colombian Stock Exchange, and life insurance proceeds, among others.

Moreover, to estimate forgone revenue DIAN applies an average marginal rate based on the information available from the tax returns at the time of publication of the MFMP; for example for the MFMP published in 2016, a 14.1% average marginal tax rate was estimated based on 2014 tax returns. Again, the accuracy of this approach could be improved. Currently the estimation uses average tax rates rather than the actual tax rates that individual taxpayers face. Applying the average marginal rate is more imprecise than applying the PIT schedule to the individual tax return. Most importantly it underestimates forgone revenue from TEs as in the case of labour, pensions, capital and non-labour income where different rates for different brackets apply. In fact, this method incorrectly assumes that all the exempt income and special deductions have no impact on the taxpayer's PIT bracket when tax expenditures are added to taxable income. Ideally, revenue forgone should be estimated at the individual level, i.e. applying the PIT schedule to individual tax returns.

A proper TE assessment involves defining a tax benchmark, including for the PIT. The importance of this exercise cannot be overstated, and requires an in-depth discussion amongst policymakers, and, possibly, the broader public. However, such an approach is necessary as it is the only way possible to decide whether certain tax provisions are a TE or not. For instance, the extent to which the tax exemption of the inflation component in the nominal return on interest income is a TE cannot be decided without defining a TE

benchmark first. If the TE benchmark would tax only the real return on savings, then the tax exemption for inflation in the return on interest income is not a TE. However, the fact that the nominal rather than the real return on equity income is currently taxed would then constitute a negative TE, as the return on equity is over-taxed. On the other hand, if the benchmark stipulates that personal capital income is taxed on a nominal rather than a real basis, then the tax exemption for the inflation component in interest income will constitute a TE.

## 2.9 Strengthen the TE unit within DIAN

The TIC encourages DIAN to develop a stand-alone comprehensive TE report that becomes a key source of information for tax policy discussions. DIAN faces many constraints in calculating TEs due to the lack of detailed information available to them. As input to the work of the TIC, DIAN has made significant efforts to improve its tax revenue foregone estimation methodology. These efforts should continue after the work of the Commission has finished, such that DIAN can publish a separate TE report that includes tax revenue foregone for each TE on an item-by-item basis as from 2021, or 2022, onwards. However, this might require changes to ensure that the income tax returns include the required information that need to be declared on an itemized basis. DIAN could incorporate these changes into the tax forms it sends to citizens as part of its modernisation programme, whereby it will employ digital technologies to streamline and simplify taxpayers' interactions with the tax administration.

It will also require additional financial and human resources for the unit within DIAN that is in charge of preparing the TE figures. This unit needs to be further developed and the toolbox that the unit applies need to be strengthened. This unit should also seek out information from international institutions who have experience of working with countries that have gone through similar processes and can draw upon best practices from across the world.

Combining these elements will allow DIAN to publish TE figures that are transparent and provide an accurate picture of the tax revenue foregone of all items that narrow the tax base in Colombia.



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# Annex 1.A.

## Comprehensive Income versus Broad-Based Consumption Tax Benchmarks

The two main conceptual tax bases used as benchmarks are the comprehensive income tax and the consumption tax. Under the Schanz-Haig-Simons definition, comprehensive income is conceptually equal to the sum of the market value of consumption and the changes in net wealth. Under a comprehensive income tax, income is taxed when it is accrued. Savings are made out of taxed earnings and the return on these savings (irrespective of whether the assets are owned directly or through a savings fund) is part of the benchmark and subject to income tax on an accrual basis. In return, the withdrawal of assets from such saving vehicles is fully exempted from tax; i.e. savings are taxed under a “taxed-taxed-exempt” regime. In contrast, a broad-based consumption tax is conceptually equal to a comprehensive income tax net of the deduction of net savings. This implies that under a comprehensive income tax benchmark any concessional taxation of income derived from capital is a TE. In contrast, under a consumption benchmark any taxation of income from capital that is reinvested (i.e. that is not used to finance consumption) constitutes a negative TE.

More specifically, under a comprehensive income tax base:

- All income from salaries, entrepreneurial activities and investments, including dividends, interest, rents, capital gains and royalties is taxed upon accrual; this income is included in the benchmark.
- Any employment related benefits that are exempt from tax (e.g. bonuses, remuneration for extra time worked, fringe benefits, etc.) are a TE.
- The deductibility of pension savings from income tax or the exemption or partial taxation of the return earned on these pension savings, including the deferral of the taxation of the return, are TEs (i.e. under an exempt-exempt-taxed pension system). In contrast, the exemption from income tax of the pension is not a TE.
- Deductions or credits for personal consumption expenditure (i.e. cost of food, cars or medical expenses incurred, etc.) are TEs.
- Housing is an investment good. Hence, a comprehensive income tax allows deductions from home mortgage interest and, possibly, for property taxes on owner-occupied housing but also includes in the tax base imputed gross rental income.

A pure consumption tax is equivalent to an exempt-exempt-taxed (EET) regime. For instance, when applied to pensions, the EET enables the deferral of tax payments until retirement. In practice, the income that is contributed to a given pension scheme is exempted, the income accruing by the savings scheme is also exempted, and then the capital is taxed when is paid-out at retirement. In this way, the taxpayer faces the same present value of post-tax income to consume in the first period or later at retirement (under the assumption that savings grow at a rate that is equal to the discount rate, and the tax rate is flat and constant over time).

# 3

## Working Party 1: Tax expenditures within the VAT

Tax Expenditures Report



### 3. Working Party 1: Tax expenditures within the VAT

*The VAT is intended to be a broad-based tax on final household consumption, but in Colombia, its poor design – characterised by extensive exclusions, exemptions and reduced rates – has led the VAT to have a narrow base. Colombia’s VAT is therefore distortive, unfair and results in high compliance and enforcement costs. It also places a significant burden on businesses and their investment. This induces businesses to locate their production – for domestic consumption – abroad and/or to buy inputs from overseas, and for consumers to buy foreign-produced goods or goods from the informal sector. These findings do not mean that the VAT should be replaced by a sales tax, but call for improving the design and functioning of the existing VAT regime.*

*The introduction of a VAT compensation mechanism in early 2020 has generated significant momentum for a broadening of the VAT base, and efforts to further extend its coverage are encouraging. If the VAT compensation mechanism cannot be fully installed in the short run, the 0% VAT rate can be maintained on a selection of items, including exports and the basket of basic needs goods, in order to satisfy the right to subsistence. The reduced VAT rate can be increased somewhat, to within a range of 10% to 12%. The government could progressively eliminate the VAT exclusions and exemptions, in particular those that are uncommon from an international perspective, and steadily increase the number of items that are taxed at the standard VAT rate of 19%. This rate should not be increased. In the medium term, the Consumption Tax should be abolished and the design of excise duties should be evaluated. Scope exists to improve the design of health and environmental excise duties. An increase in VAT revenues from adopting these measures is expected.*

*Although smaller than previously estimated, the revenue forgone from VAT exclusions remains high and points at the large revenue potential of improving the design of the VAT.*

#### 3.1 Introduction

The VAT is intended to be a broad-based tax on final household consumption in the jurisdiction where the use or final consumption occurs. A VAT is a tax on final consumption by households as, in principle, only private individuals, as distinguished from businesses, engage in the consumption at which a VAT is targeted. A necessary consequence of the fundamental proposition that a VAT is a tax on final consumption by households is that the burden of the VAT should not rest on businesses.

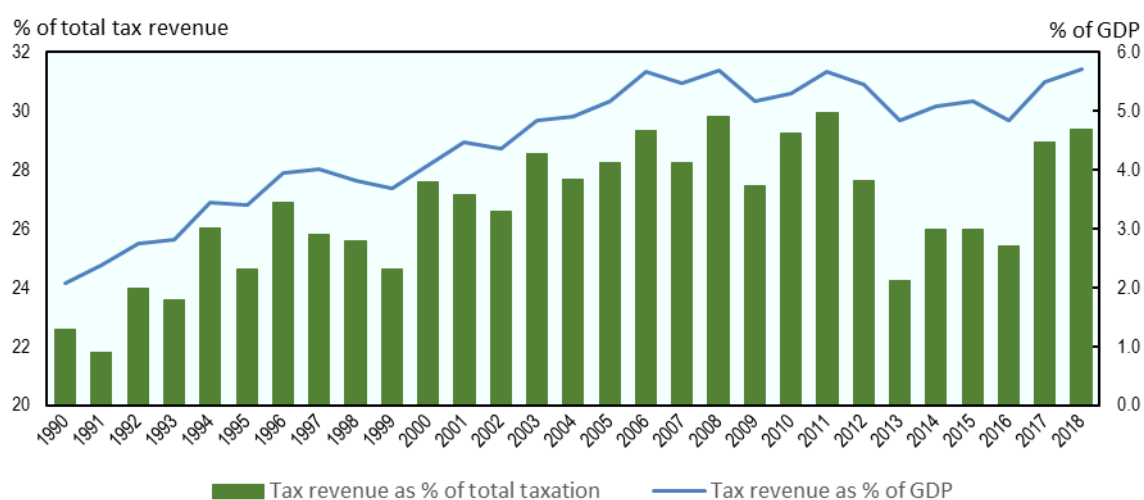
Under its standard design, VAT is collected by businesses through a staged process on the “value added” at each stage of production and distribution. Each business in the supply chain takes part in the process of controlling and collecting the tax, remitting the proportion of tax corresponding to its margin, i.e. on the difference between the VAT imposed on its taxed inputs and the VAT imposed on its taxed outputs. In general, jurisdictions with a VAT allow the deduction of VAT on purchases by all but the final consumer. This design feature gives to the VAT its essential character in domestic trade as an economically neutral tax. The full right to deduct input tax through the supply chain, except by the final consumer, ensures the neutrality of the tax, whatever the nature of the product, the structure of the distribution chain, and the means used for its delivery (e.g. retail stores, physical delivery, internet downloads). As a result of the staged payment system, VAT thereby “flows through the businesses” to tax supplies made to final consumers.

The design of the VAT in Colombia is not fully aligned with these design features. First, the Colombian VAT creates a burden on investment. In Colombia, businesses need to pay VAT on their investment, as in other countries that levy a VAT, but in contrast to other countries, they cannot deduct the VAT paid on investment from the VAT they levy on their outputs. Instead, businesses receive a CIT credit for the underlying VAT paid. Second, for a limited number of items, the multi-staged collection process has been replaced by a single collection mechanism.

The standard VAT rate in Colombia is 19%, which is not particularly low. In addition to its 0% rate, Colombia also levies a VAT reduced rate of 5%. In 2018, the VAT in Colombia raised 5.7% of GDP in revenues, which constitutes 29.4% of total tax revenues. As shown in Figure 1.1, VAT revenues as a share of GDP and as a share of the tax mix, steadily increased until 2006. Since then, the revenues collected from the VAT have remained relatively constant with a brief decrease in the share of total tax revenues between 2013 and 2016.

In all countries around the world that levy VAT, the right to deduct input tax may be restricted in a number of ways. Some are deliberate and some result from imperfect administration. Countries differ in the extent to which they exempt (in the Andean Community's terminology "VAT excluded") goods and services from the VAT and, therefore deny businesses the right to deduct input tax. Countries might also apply zero-rate goods and services (in the Andean Community's terminology "VAT exempt") but, in this case, businesses maintain the right to receive a refund for the VAT they have paid on their inputs. In the remainder of the text, we will use the VAT terminology that is commonly used in Colombia.

**Figure 3.1: VAT revenues as a share of total tax revenue and GDP (2018)**



Source: OECD Revenue Statistics database.

VAT exclusions lead to cascading effects, except if applied in the final stage of supply changes, and can encourage the granting of further exclusions to prevent this issue. The unrecoverable input VAT becomes a cost for businesses selling VAT-excluded products. This input VAT is likely to be embedded in the price of excluded products. In fact, businesses might either shift that extra tax burden onto their customers by raising sale prices, by paying their workers a lower salary, or bear (part of) the cost of unrecovered VAT themselves through a reduction of their profit margin. Who actually bears the cost requires an empirical analysis. As a result, VAT exclusions distort the input choices of businesses that face an incentive to buy inputs with little or no tax on them (including inputs purchased from the informal sector). Exclusions also create the incentive for businesses to undertake activities they otherwise would outsource. Exclusions can also discourage investment, as sellers of VAT-excluded products will not recover the VAT paid on

investment in fixed assets. Exclusions typically lead to pressures to grant further VAT exclusions on the inputs used by suppliers of VAT-excluded products, but such a strategy just aggravates the distortions introduced by excluding certain transactions.

The practice of VAT excluded goods and services is widely used in Colombia where it even applies to business investment, irrespective of whether the product produced is excluded from VAT or not. Levying VAT on investment increases the cost of capital and discourages investment. Overall, very little data and analysis has been carried out to analyse the impact of VAT exclusions on price levels – as a result of tax cascading – and the distributional impact of the VAT in Colombia.

The VAT follows the destination principle according to which the VAT taxing rights on cross-border supplies are to be allocated to the jurisdiction where the use or final consumption occurs. This means that imports are taxed under the VAT when goods and services enter the country, and exports are VAT zero-rated. As the zero-rate on exports is a structural element of the VAT, it is not considered a VAT tax expenditure. In fact, the wide range of VAT exclusions makes it more attractive to import goods from abroad than producing and buying them from local producers in Colombia. As the price of domestically produced excluded goods might include some unrecoverable VAT, this might not be the case if the goods are imported from a country where the producer was entitled to a full credit for the input VAT paid. As a result, the wide range of VAT exclusions in Colombia generates a competitive disadvantage for local production.

### **VAT registration threshold**

In many countries, small businesses that fall below the VAT registration threshold remain outside of the VAT system. In general, setting the VAT registration threshold at an adequate level is a complex task. The main reason for excluding small businesses from the VAT system is that compliance costs for small businesses may be disproportionate compared to their turnover, and that the costs for the tax administration of having very small businesses pay VAT may be disproportionate compared to potential VAT revenues. On the other hand, a VAT registration threshold introduces competitive distortions between small businesses below and above the threshold. Overall, the VAT registration threshold should minimise competitive distortions and be set so that the revenues collected are higher than the administrative costs of ensuring that small businesses properly collect and remit VAT. In general, a higher threshold is considered more appropriate in countries where the tax administration tends to be weaker.

Colombia differentiates between “responsible” and “non-responsible” businesses, where “non-responsible” businesses remain outside of the VAT system and are not obliged to withhold VAT on their sales.<sup>8</sup> The general rule for a business to be considered as “non-responsible” is that its gross income in the current or immediately preceding tax year must be below 3 500 UVT (approximately USD 34 000 or COP 125 million in 2020), which is lower than in many other OECD countries although it should be noted that price levels in most OECD countries are higher than in Colombia (see Figure 3.2).<sup>9</sup> In addition, it may not have more than one office or establishment; its activities may not fall under a franchise, concession, royalty or other intangible exploitation scheme; and it may not have bank deposits or investments greater or equal to 3 500 UVT in the current or immediately preceding tax year.

The question of whether there is scope to lower the VAT registration threshold in Colombia requires an in-depth evaluation. In light of the broader tax administrative challenges that the country is facing, lowering the VAT registration threshold should probably not be a policy priority in the short run. One option that could be considered is to lower the threshold for businesses such as liberal professions that face lower costs in terms of material inputs. Estimations by DIAN indicate that lowering the VAT registration threshold

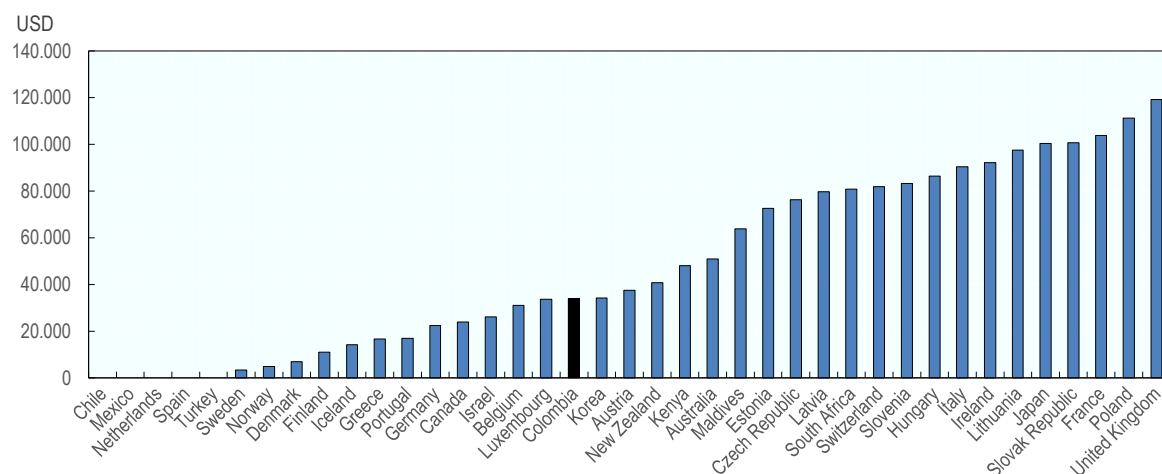
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<sup>8</sup> Businesses can include both individuals and entities. However, the non-responsible regime applies only to individuals (Section 437 CTC of the Colombian Tax Law). Consequently, corporations and other entities are out of scope of the non-responsible regime.

<sup>9</sup> This threshold is set at 4 000 UVT for those taxpayers that provide services to the State.

to 1 400 UVT (approximately USD 13 000 or COP 50 million) for liberal professions would potentially increase VAT revenues significantly.

**Figure 3.2: Compulsory VAT registration thresholds expressed in USD**



Source: OECD Tax Database

### Distributional impact of VAT expenditures

With the exception of Chile, all OECD countries have one or more reduced VAT rates to support various policy objectives. A major reason for the introduction of a differentiated rate structure is the promotion of equity. Countries have generally considered it desirable to alleviate the tax burden on goods and services that form a larger share of expenditure of the poorest households (e.g. basic food, water). Countries also often decide not to tax medicine, health services and housing at high rates. Reduced VAT rates have also been used to stimulate the consumption of “merit” goods (e.g. cultural products and education) and other non-distributional objectives such as promoting locally supplied labour-intensive activities (e.g. tourism) and correcting externalities (e.g. energy-saving appliances).

In general, VAT exclusions, exemptions and reduced rates are not a well-targeted tool to support low-income households. Reduced rates that are implemented in countries for the distinct purpose of supporting the poor (i.e. to address distributional goals) typically do have the desired progressive effect. For example, reduced rates for basic food provide in general greater support to the poor than the rich as a proportion of household income or expenditure. However, despite this progressive effect, these reduced VAT rates are a very poor tool for targeting support to poor households. At best, rich households receive roughly as much benefit – in absolute value – from a reduced rate as do poor households. At worst, rich households benefit vastly more than poor households. This result is unsurprising as better off households can be expected to consume more, and often more expensive, products than poorer households. Thus, while poorer households may benefit from reduced VAT rates on “necessities” the wealthier gain even more.

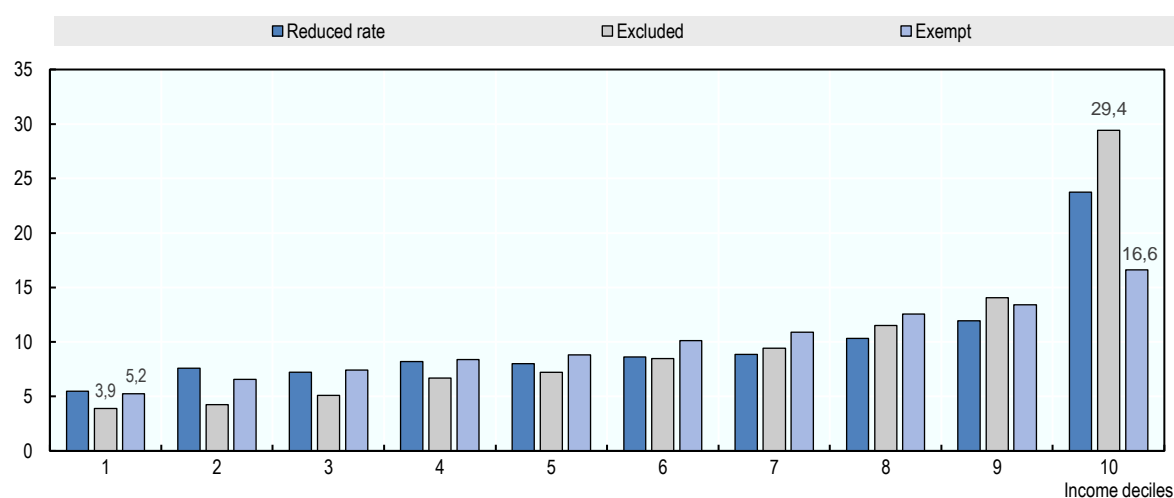
Cash transfer programmes that cover the entire population, if well-functioning, are a more effective tool to compensate poor households for the VAT they have paid. If poor households can be compensated directly through a cash transfer programme, it is more efficient and fair to tax all goods and services at the standard VAT rate and compensate the poor directly through cash transfers (and/ or reductions in personal income taxes, etc.), especially if the standard VAT rate is not particularly high. It should immediately be noted, however, that compensating all (and only the) losers from a reform through a transfer programme

might in practice be very difficult to achieve. The identification system for potential beneficiaries of social programs, SISBEN IV, is a promising tool to implement a well-functioning compensation mechanism.

With regard to preferential VAT provisions for social, cultural and other non-distributional goals, richer households benefit considerably more from VAT exclusions and reduced rates. Those tax provisions often provide so large a benefit to rich households that the reduced VAT rate actually has a regressive effect – benefiting the rich more both in aggregate terms and as a proportion of expenditure. For example, reduced rates on hotel accommodation and restaurant food benefit the rich vastly more than the poor, both in aggregate and proportional terms, in all OECD countries in which they are applied. Similar results, but of less absolute magnitude, are found for reduced rates on books, cinema, theatre and concerts.

Finally, VAT rate differentiation might not be the best policy instrument to correct negative externalities. VAT rate differentiation may improve efficiency if it means that the private marginal costs of an activity are brought closer to the marginal costs for society. However, VAT is a blunt instrument for addressing environmental externalities, as it may be hard to target the actual source of pollution. For example, reduced rates on energy-saving appliances may boost demand for them and therefore stimulate the consumption of these goods. The reduced VAT rate may give incentives to shift from more to less energy-consuming items (consumers might replace their old refrigerator with a new one, for instance). However, this may also lead to an increase in the purchase of energy-intensive products (e.g. consumers may replace their old refrigerator with a new refrigerator and a freezer).

**Figure 3.3. Participation of each decile in expenditure of goods and services subject to VAT concession**



Source: ENPH 2017, DGPM-MHCP. Estimates based on household consumption survey data.

High-income households benefit disproportionately from VAT reduced rates, exclusions and exemptions (as a percentage of expenditure). Because high income households account for larger shares of total expenditure in goods and services subject to VAT concessions, these households are the ones that benefit the most from these concessions (in absolute amounts). This is even more so if a larger share of low income household expenditure is bought from the informal market. According to estimates from DIAN and the Ministry of Finance (see Figure 3.3), out of every 100 pesos “saved” by households from VAT exemptions, the top decile benefits by 16.6 pesos while the lowest decile benefits by 5.2. Similarly, out of 100 pesos saved on VAT exclusions the top decile saves 29.4 versus 3.9 saved by the lowest decile. It should be noted that these estimates are based on expenditure data from the household consumption survey (ENPH, 2017) and assume consumers benefit fully from VAT concessions (i.e. that there is full pass through to prices) while the literature on this issue is mixed (see for example Kosonen, 2015; Benzarti and Carloni, 2019;



Benedek, de Mooij, Keen and Wingender, 2019). In the case of excluded goods the analysis of whether households fully benefit from the exclusion is even less straightforward as businesses are likely to pass (partly or fully) the non-refundable input VAT into prices of goods and services they sell.

### **VAT and the informal economy**

VAT fraud takes many forms. Common forms of VAT fraud involve businesses that should be registered for VAT not registering, by remaining completely informal, artificially splitting activities into smaller businesses or under-reporting sales to remain under the compulsory VAT registration threshold. Non-compliance may also occur with VAT-registered businesses: some may for instance under-report taxable supplies (e.g. through automated sales suppression devices or “zappers”) or overstate purchases for which they can deduct input VAT (through false invoices); others may even disappear without remitting VAT to the government.

In theory, VAT can incentivise informal businesses to become formal, but this does not always happen in practice. VAT increases the tax burden on the informal sector as informal businesses might have to pay at least some VAT on their inputs, which they are not entitled to deduct. This is especially true if goods are imported, as VAT is collected at the border when goods enter the country. VAT collected on imports effectively becomes a tariff for informal businesses while VAT-registered firms can reclaim the VAT they paid on their imports (Keen, 2008<sup>[1]</sup>). The ability to recover input VAT may give informal businesses a strong incentive to become formal, creating positive “chain effects” (de Paula and Scheinkman, 2010<sup>[2]</sup>). However, informal businesses may purchase their inputs from informal suppliers, which means that there might be little VAT paid on imported inputs that needs to be recovered and therefore that the incentives to become formal are more limited. Informal businesses then compete with formal VAT registered businesses (Emran and Stiglitz, 2005<sup>[3]</sup>). To face competition from informal businesses that are not registered for VAT and therefore do not charge VAT, formal VAT-registered businesses may end up bearing at least a part of the VAT burden themselves by charging lower pre-tax prices.

### **Constitutional Court's impact on VAT policy in Colombia**

Previous Constitutional Court rulings suggest that there may be some constraints to reforming the VAT. Equity<sup>10</sup>, efficiency and progressivity were established as fundamentals of the Colombian tax system, under Article 363 of the Colombian Constitution. The Colombian Constitutional Court has been consistent in stating that preferential treatments such as exemptions and exclusions are contrary to the principle of equity unless they are justified for relevant social or economic interest (ruling C-1060A/01). Decisions to tax certain goods and services with a social impact may also be contrary to the principle of progressivity and thus must be accompanied by measures to reduce inequality (such as the compensation mechanism) between high- and low-income households (ruling C-766/03).

The Court overruled a law that imposed a 2% VAT over all goods pertaining to the primary goods category – stating that taxing all primary goods was against the minimum living standard (ruling C-776/03). According to this ruling, the taxation of primary goods consumed to satisfy basic needs (the basic needs basket), defined as those goods that are required to satisfy the “right to subsistence”, should be accompanied with measures to guarantee progressivity, such as taxation at differential rates or the introduction of refund mechanisms. In other words, the Constitutional Court considers it viable to tax all goods and services as long as there are social compensatory measures that enable the offsetting of regressive effects. Recently the Constitutional Court declared sanitary towels VAT exempt (ruling C-117/18), arguing that this product is indispensable for women and should therefore not be taxed.

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<sup>10</sup> Horizontal equity implies that individuals, companies, or entities with similar economic capacity must be taxed in a similar way. Vertical equity requires that subjects with higher economic capacity must bear a higher tax burden (Constitutional Court, C-600/15).

It should be noted that it is not always clear that consumers will benefit from VAT exemptions, exclusions or reduced rates. By taking into account consumers' willingness to pay, producers might just decide to increase their before-tax prices in response to the reduced VAT burden. Preferential VAT treatment might therefore increase profits of suppliers rather than lowering the price for the consumer if the preferential VAT treatment is not passed through to consumer prices. The decision to exempt or exclude goods might even be counterproductive if prices were to increase by even more than the standard VAT rate.

Regarding Congress' overall ability to repeal or amend tax benefits, the Constitutional Court has concluded that the Congress has broad taxing powers, which include the possibility of creating, repealing, amending or substituting existing tax benefits.<sup>11</sup> There is however no mechanism for the government to get an opinion from the Constitutional Court in advance about the constitutionality of a proposal to eliminate a tax incentive. As a result, the government must make its own judgment of the current jurisprudence when submitting a bill or issuing a Legislative Decree regarding tax incentives.

Although the government must abide by the before mentioned principles of equity, efficiency and progressivity, the Congress has the freedom to repeal, amend, modify or substitute such generic tax benefits, in response to tax policy needs.<sup>12</sup> Additionally, the taxpayers that enjoy such generic tax benefits (e.g., VAT exclusions and exemptions) do not have a right to retain the benefits in case they are repealed.

### **Andean Community's impact on VAT policy in Colombia**

Under Decision 599, the Andean Community established a number of parameters pertaining to the VAT systems of member countries. It established a number of limits on preferential treatments, whereby: (i) only exported goods are VAT exempt; (ii) excluded goods are prohibited, except for education, health, transportation, and financial services; (iii) for selected goods, a minimum VAT rate could be applied of no less than 30% of the maximum rate. Though compliance with this decision is legally binding, some members of the Community have yet to comply fully with the Decision

In general terms, Decision 599 follows the same structure as the Colombian VAT regime by taxing sales of goods, the supply of services and imports. However, some rules differ, especially regarding preferential VAT treatments, notably:

- Article 19 states that the maximum general VAT tax rate applicable cannot be higher than 19%. This article also states that member states cannot adopt more than one preferential rate, which cannot be lower than 30% of the general VAT tax rate (i.e. 5.7%);
- Article 20 of Decision 599 only allows VAT exemptions (zero rate) for exports of goods and services;
- Article 23 states that member states shall refrain from incorporating new exclusions of goods or expanding existing exclusions in domestic legislation. Exclusions will only be permitted for goods imported by diplomatic and consular missions, and international organizations with the required accreditation, donated goods destined for the public sector and private non-profit organizations in certain sectors, and accompanied and unaccompanied luggage;
- Article 23 also states that incorporating new exclusions of services or expand existing ones in their domestic legislation will not be permitted. Exclusions are, however, permitted for education, health, national passenger transport, and financial intermediation services, while temporary exclusions and exemptions are allowed in the case of severe financial crisis or to attend to national emergencies;

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<sup>11</sup> Rulings C-222 of 1995, C-341 of 1998, C-250 of 2003, C-1003 of 2004, C-664 of 2009.

<sup>12</sup> Rulings C 304 of 2019.

- Decision 599 also instructed the Andean Community member countries to eliminate the zero-rate tax regime (exemption) by 2019, exports excluded;
- Additionally, the Decision ordered member countries to eliminate the exclusions not included on article 23 by 2019.

However, there are notable number of items that were deemed out of the scope of Decision 599 that relate to the Working Parties of the Tax Incentives Commission. These items include tax free zones and regimes, or any geographical or regional benefits or regimes included in each country's internal legislation, which are to be governed by domestic laws and other special regulations.

## 3.2 VAT Expenditures in Colombia

### A wide range of VAT TEs

Colombia has a wide range of VAT TEs, which can be differentiated in three broad groups: VAT exclusions, VAT exemptions and VAT reduced rates. In addition, VAT is not applied in certain geographical regions (Amazonas, Guainía, Guaviare, and Vaupes, among others). Furthermore, there are certain sectors such as construction engineering, for which VAT is calculated differently under some circumstances whereby, instead of being levied on value added, it is taxed on profits.<sup>13</sup> This also applies to cafeterias, cleaning services and surveillance. The tax policy rationale for such an approach is weak. Moreover, transactions with Free Trade Zones (FTZs) are also exempted from the VAT, but that topic will be covered in the chapter that covers the FTZ regime.

Some of the most important VAT TEs are listed below (non-exhaustive list):

- VAT exclusions:
  - Public administration, health sector, education sector, financial sector, domestic services, cultural, sports and recreational services, agricultural sector, passenger transport, electricity, gas and water, fruits, vegetables;
- VAT exemptions:
  - Books, newspapers and magazines, meat, fish, rice, milk, eggs, cheese, medicine, bicycles<sup>14</sup>, motorcycles;
- VAT reduced rates:
  - Electric vehicles, gasoline and diesel<sup>15</sup>, different types of alcohol, pasta, cereal products.

### Tax revenue forgone

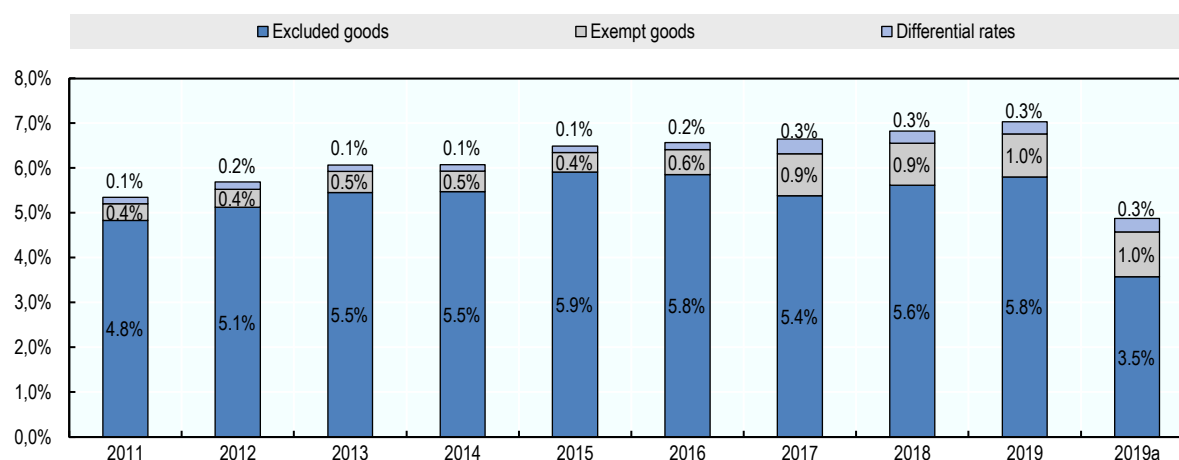
The tax revenue foregone in Colombia of VAT TEs is large. The figures originally provided by the tax administration indicated that VAT TEs amounted to 7.1% of GDP in 2019, a significant increase from 5.3% of GDP in 2011 (see Figure 3.4). However, improvements in the methodology used to estimate revenue forgone (see the TE reporting chapter for more detail) have revealed that VAT exclusions are notably over-estimated. The new estimations show that in 2019 the revenue forgone from VAT excluded goods and services was estimated to be closer to 3.5% of GDP, down from 5.8% as previously estimated. VAT expenditures on exempt goods and differential rates remained unchanged at 1% at 0.3%, respectively.

<sup>13</sup> Construction services are subject to VAT. However, the tax is levied exclusively over the service fees obtained by the constructor. When fees are not agreed, the tax will trigger on the profit of the builder. The only input-VAT that can be credited is input-VAT directly associated with the provision of the service. VAT paid over costs and expenses necessary for the construction of the building are non-creditable.

<sup>14</sup> The exemption for bicycles and motorcycles applies only to those sold in the regions of the Amazon, Guainía, Guaviare, Vaupés and Vichada (Section 477 CTC).

<sup>15</sup> The 5% VAT reduced rate applies exclusively on the income made by the producer (Section 468-1 TC).

Figure 3.4. VAT expenditures as a % of GDP



Notes: The data shown in the 2019a bar of the figure illustrate adjustments to the services that are considered to be excluded. In particular, non-market services (such as the provision of free health, education and public administration services), imputed rent from residential houses and illegal consumption of certain horticultural products are no longer considered when calculating potential revenue..

Source: Marco Fiscal de Mediano Plazo 2020 and revised estimates by DIAN for 2019.

VAT TEs as a whole have grown steadily since 2011 (see Figure 3.4). However, it is difficult to determine what role VAT exclusions specifically had within this growth in TEs given the changes to the estimation methodology brought about by the TIC – many goods and services, though mainly goods, should not have been considered as excluded by DIAN in their previous estimations prior to the TIC. Additionally, the revenue forgone from VAT exemptions and reduced rates has also increased over time. The 2011/2012 tax reform reassigned goods and services among excluded, exempt and reduced rate categories, which had an impact on the amount of tax revenue foregone. Another reason for the increase in VAT TEs is that some goods and services were taken out of the scope of the VAT and taxed under the consumption tax instead. Furthermore, economic growth might also have induced households to diversify their consumption bundle and to start consuming more goods that receive more favourable tax treatment. Overall, the distortions and inequities of the Colombian VAT have become more pronounced over time.

The largest VAT exclusions are linked to goods and services from the following sectors: agriculture, fishing and mining, financial services and real estate services (see Table 3.1). The largest VAT TEs in relation to exempted goods and services are presented in Table 3.2. The revenue forgone from reduced rates (see Table 3.3) applied to gasoline and diesel sold to intermediaries and alcoholic beverages amount to COP 872 and 372 thousand million, respectively (approximately USD 200 million and USD 100 million).

**Table 3.1 VAT revenue forgone from excluded goods and services, 2019 adjusted, COP thousand millions**

Agricultural and horticultural products	6 006
Financial services	3 861
Real estate services	3 711
Services to support agriculture, fishing and mining	3 039
Educational services	2 984
Passenger transport, freight transport and vehicle hire	2 548
Construction	2 081
Other excluded goods and services	12 898
<b>Total</b>	<b>37 127</b>

Source: Marco Fiscal de Mediano Plazo 2020 and revised estimates by DIAN

**Table 3.2 VAT revenue forgone from exempted goods and services, 2019, COP thousand millions**

Milk, meat and eggs	5 942
Books and magazines	287
Biodiesel	1 834
Other goods	21
Internet connection for low income households	239
<b>Total</b>	<b>8 323</b>

Notes: Excludes VAT revenue forgone in Free Trade Zones.

Source: MFMP 2020.

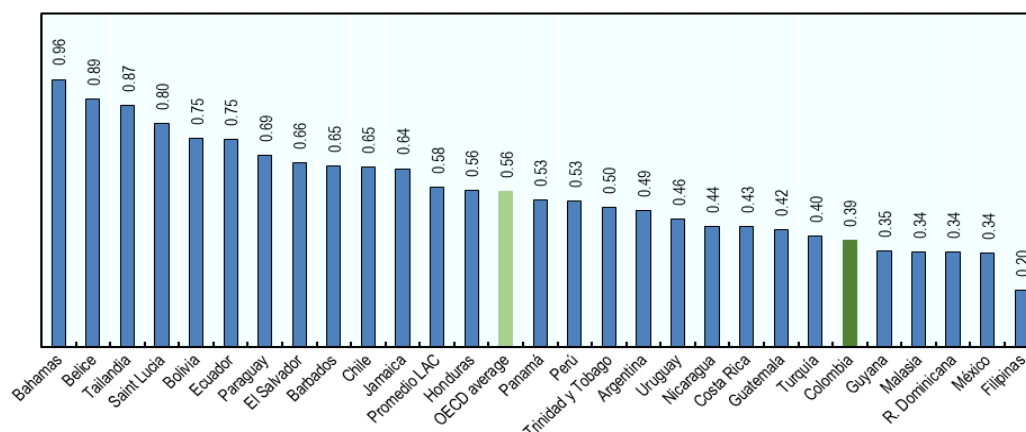
**Table 3.3 VAT revenue forgone from reduced rates, 2019, COP thousand millions**

<b>Goods</b>	<b>3 044</b>
Gasoline and diesel	872
Animal feed	509
Brandy and rum	230
Whisky, brandy, vodka and their concentrates	92
Wine and cider	50
Other goods	1 291
<b>Services</b>	<b>430</b>
Pre-paid health	417
Other services	13
<b>Total</b>	<b>3 474</b>

Source: MFMP 2020.

### Under-performance of the VAT in Colombia

The VAT in Colombia is under-performing, as reflected by the low value of the VAT revenue ratio (VRR) in Figure 3.5. The under-performance is partly due to the large TEs as well as enforcement challenges. The VRR presents the actual VAT revenues collected by DIAN as a percentage of the revenues that could be raised if all final consumption would have been taxed at the standard VAT rate under perfect enforcement. Colombia collects less than 40% of the possible revenues. In fact, the VRR in Colombia is tilted upwards because of the VAT paid on investment that raises a significant amount of tax revenues. Without the VAT on investment, the VRR would be even lower.

**Figure 3.5: VAT revenue ratio (2018)**

Source: OECD Revenue statistics database.

### 3.3 Categorisation of VAT expenditures in Colombia

Colombia has a wide range of goods and services that are excluded, exempt or taxed at the reduced VAT rate. This section focuses on the most important TEs. These TEs are assigned to four reform categories<sup>16</sup>:

- Category I: no reform is recommended, at least in the short run
- Category II: reform is desirable
- Category III: reform might be possible over time conditional upon the implementation of accompanying tax reforms
- Category IV: Unclear whether to reform or not

This categorisation is carried out separately for VAT exclusions, VAT exemptions and VAT reduced rates, in three separate tables. It is important to point out that the analysis in this section is indicative only, as a decision of whether or not a specific TE could be abolished would ideally require a full cost-benefit analysis. This tentative categorisation takes into account the following dimensions:

- The tax revenue foregone;
- The distributional implications, in particular if the TE has a significant regressive distributional impact;
- The negative externality effects tax incentives generate, among the most notable environmental and health effects;
- The efficiency implications;
- The impact on the complexity of the tax system, the extent to which the TE creates tax planning and avoidance opportunities, and the extent to which the TE creates challenges with respect to its administration, compliance and enforcement.

Whether or not an opportunity exists to broaden the VAT base by abolishing the particular TE will involve making trade-offs between the different costs and benefits of each TE, building upon empirical data for the different dimensions involved. Indeed, such an analysis requires more data than currently is available. Moreover, a full-cost benefit analysis for each TE goes beyond the scope of this assessment. The analysis below provides a general discussion that explains the tentative categorisation made by the commission based on the dimensions introduced above.

**Table 3.4 Reform categories for VAT exclusions**

	<b>Category I: No reform</b> (at least not in short run)	<b>Category II: reform is desirable</b>	<b>Category III: reform is conditional</b>	<b>Category IV: Unclear whether to reform or not</b>
VAT exclusions	<ul style="list-style-type: none"> <li>• Real estate services to individuals</li> <li>• Public administration services, mandatory social security services</li> <li>• Support services to public services</li> </ul>	<ul style="list-style-type: none"> <li>• Recreational services</li> <li>• Cultural activities</li> <li>• Sports activities</li> <li>• Transportation support services</li> <li>• Other chemicals and artificial fibres</li> <li>• Crude oil</li> </ul>	<ul style="list-style-type: none"> <li>• Agricultural and horticultural products</li> <li>• Passenger transport</li> <li>• Natural gas</li> <li>• Support services to agriculture sector, including</li> </ul>	<ul style="list-style-type: none"> <li>• Sewage, collection, treatment and disposal of waste</li> </ul>

<sup>16</sup> A fifth category is discussed in other framing notes when determining whether the concession is a TE or not depends on the benchmark choice. Regarding VAT it is broadly agreed that any reduced rates, exemptions (other than exported goods and services) and exclusions are a TE.

<ul style="list-style-type: none"> <li>• Human health care and social services</li> <li>• Education services</li> <li>• Financial and related services</li> <li>• Domestic services</li> </ul>	<ul style="list-style-type: none"> <li>• Basic chemicals</li> <li>• Paper and paper products, printed material and related articles</li> <li>• Certain telecommunications services, including transmission and information provision services</li> <li>• The VAT excluded internet connection and access services<sup>17</sup></li> <li>• Cloud computing, hosting and web design</li> <li>• Advertising on radio and TV</li> <li>• Computers for personal use of less than 50 TUV and tables and cell phones of less than 22 TVU</li> <li>• Coal, lignite and peat</li> <li>• Rubber and plastic products</li> <li>• Certain engines and tires</li> <li>• Transport in general (except passenger transport by road or rail)</li> <li>• Consulting services provided by education centres</li> </ul>	<ul style="list-style-type: none"> <li>• insecticides and fertilisers</li> <li>• Electricity, gas and water as well as the linked distribution services</li> <li>• Meat, fish, fruits, vegetables, oils and fats</li> <li>• Natural water</li> <li>• Machinery for agricultural use</li> <li>• Territorial exclusions</li> </ul>	
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Source: DIAN and Ministry of Finance officials.

**Category I** includes a wide range of VAT exclusions that are common in the OECD and that are permitted by the Andean Community. Exclusions generally applied in most OECD countries and that could remain excluded from VAT in Colombia include: public services, transport of sick/injured persons; hospital and medical care; human blood, tissues and organs; dental care; charitable work; education; non-commercial activities of non-profit making organisations; insurance and reinsurance; letting of immovable property; financial services; supply of land and buildings (OECD, 2019). In line with common practice, government services, real estate, education, health care and financial services are included in this category. Domestic services are included as the VAT exclusion is not uncommon and has a labour market rationale (to stimulate demand). The case for excluding (public and/or private) postal services from VAT remains open for discussion.

**Category II** refers to items for which the rationale of maintaining these concessions seems particularly weak. Some of the VAT exclusions included in Category II refer to consumption of goods and services that generates negative environmental externalities such as crude oil, gas, coal and paper. VAT exclusions on recreational services are likely highly regressive while the revenue forgone is likely high. VAT exclusion on cultural and sports activities, although common in OECD countries, are also regressive and thereby were included in this category. Consulting services provided by universities and other educational institutions are VAT excluded. The rationale for excluding these type of services is weak.

<sup>17</sup> The exempted internet connection and access services apply to stratum 1 and 2 (Section 476 CTC). Internet for stratum 3 is VAT excluded, and for stratum 4, 5 and 6, internet connection services are taxed at the general rate.

**Category III** includes the items for which abolishing the exclusions might have significant distributional implications – these exclusions can be abolished once the VAT compensation mechanism is fully rolled out and operational. This is clearly the case of passenger transport (by road and train); eliminating this exclusion is conditional on the broadening of the compensation mechanism, as the impact of this elimination is likely regressive. The same line of reasoning can be followed with respect to the VAT exclusion on electricity, gas and water consumption, as well as to sanitary napkins and towels. A possible base broadening reform would have to evaluate the interaction with the fact that prices are regulated; it may require accompanying regulated price changes. These VAT exclusions are likely a major source of revenue forgone, but eliminating them would have a significant distributional impact if not accompanied with compensating measures for the poorest.

The agricultural sector remains excluded from the VAT (this will be discussed in more detail below). Over time, the sector could be brought within the standard VAT treatment. Once the VAT compensation mechanism can offset the poor for the VAT paid on agricultural products, all other items that are used as input by the agricultural sector can then also be brought within the scope of the standard VAT, as the agricultural sector will be able to obtain a credit for input VAT.

Colombia should levy VAT on insecticides and fertilizers. Excluding these goods from VAT is uncommon in OECD countries (OECD, 2020a). When evaluating whether this exclusion is justified or not, the environmental externalities associated to the use of both insecticides and fertilizers should be taken into account. Excluding these inputs from VAT may imply higher rather than lower costs to farmers if non-refundable VAT costs from industries that produce these goods are passed on to insecticides and fertilizer prices.

The exclusion of certain territories from the VAT does not constitute good tax policy, in particular because other VAT policy design features allow to tackle the challenges that consumers and businesses in these regions face. The excluded regions are very poor, which implies that many businesses in these regions would fall below the VAT registration threshold and would not be liable for VAT. Consumers who buy goods or services from these businesses would not pay VAT either. However, the regional VAT exclusion creates distortions, as it may induce Colombian businesses to falsely route their transactions through these regions in order to avoid paying tax.

In addition to VAT exclusions, Colombia has a wide range of goods and services that are VAT exempt (see Table 3.5). Most VAT exemptions in Table 3.5 can be reformed and taxed at the standard VAT rate, and they are therefore included in **Category II**. Optimal tax policy calls for a broad VAT base where all goods and services are levied at the standard VAT rate. Excise duties play a role as complement to tax goods that generate negative externalities linked to health or the environment (see discussion on excises in subsection below). Ideally, VAT should apply to all fuels (including biodiesel and fuel alcohol) and excise taxes should be levied on those fuels that generate the largest negative environmental externalities. Negative environmental externalities associated to the use of motorcycles justify eliminating this VAT exemption on the purchase of these goods.

**Table 3.5 Reform categories for VAT exemptions**

	<b>Category I: No reform (at least not in short run)</b>	<b>Category II: reform is desirable</b>	<b>Category III: reform is conditional</b>	<b>Category IV: Unclear whether to reform or not</b>
VAT exemptions		<ul style="list-style-type: none"> <li>Scientific and cultural books, newspapers, magazines and periodicals</li> <li>Beef, pork meat, meat of sheep, goats</li> <li>Mixed biodiesel</li> </ul>	<ul style="list-style-type: none"> <li>Rice, milk, cream, eggs, fish, cheese</li> <li>Bicycles</li> <li>Sanitary napkins and towels</li> </ul>	



		<ul style="list-style-type: none"> <li>• Fuel alcohol</li> <li>• The VAT exempt internet connection and access services</li> <li>• Weapons and ammunition (insofar sold to private individuals and non-governmental organisations)</li> <li>• Motorcycles</li> <li>• VAT holidays</li> </ul>		
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Source: DIAN and Ministry of Finance officials.

The sale of weapons and ammunition to private individuals and non-governmental organisations could be included within the VAT; the argument that most of them are sold by government (and also that the VAT exemption is allowed by the ANDEAN community) does not constitute a strong reason not to levy the standard VAT rate. On the contrary, as the demand is probably quite price inelastic, there are good reasons to levy the tax under the standard VAT rate (and very likely with an additional excise duty to pay for the additional costs that society incurs because of the circulation of weapons in society).

Meat consumption is a substantial source of CO<sub>2</sub> emissions. This externality should be taken into account when evaluating the justification for preferential taxation. However, applying VAT to meat is likely to have a negative distributional impact. Ideally, once the VAT compensation mechanism is fully operational, this impact could be offset.

Applying the VAT standard rate to scientific and cultural books, newspapers, magazines, and periodicals is desirable. While the tax exemption is allowed by the ANDEAN community, the TE is regressive and removing it creates an opportunity for VAT base broadening, possibly by applying the standard VAT rate or, as a temporary transition measure, levying a reduced VAT rate in the range of 10% to 12%. This would bring Colombia more in line with OECD countries, though that said, OECD countries also vary notably in the approach they take as described in the OECD's Consumption Tax Trends report (OECD 2020b). An economic assessment of the VAT exemption and of increasing the reduced VAT rate is recommended in order to support these decisions, and should include an analysis of the distributional implications of these reforms.

In 2019 Colombia introduced three VAT-free days during which specified goods including clothes, home appliances, sports elements, toys and school supplies could be bought without VAT being levied. This measure was temporarily extended in 2020 in the context of the COVID crisis. Whilst government data has indicated that this practice did not lead to tax sacrifices and has increased consumption, the TIC would not encourage DIAN to renew this practice once the COVID crisis is over as VAT-free days can be inequitable, may discourage tax compliance and distort the efficient functioning of the market.

Overall, the items in [Category III](#) can be taxed at the standard rate once the VAT compensation mechanism is fully operational and reaches all the vulnerable population.

Finally, Colombia also taxes a range of goods and services at a reduced VAT rate. These items are listed in Table 3.6.

[Category I](#): In general, subsidising “the good” (i.e. electric transport, electric vehicle engines and electric motorcycles and bicycles) rather than taxing “the bad” (fossil fuels, etc.) is not a preferred tax policy approach. However, in the short run the tax subsidies for electric transport could be maintained at least until the taxes on fossil fuels and other goods that are damaging for the environment have been increased.

**Table 3.6 Reform categories for VAT reduced rates**

	<b>Category I: No reform (at least not in short run)</b>	<b>Category II: reform is desirable</b>	<b>Category III: reform is conditional</b>	<b>Category IV: Unclear whether to reform or not</b>
VAT reduced rates	<ul style="list-style-type: none"> <li>• Electric vehicle engines</li> <li>• Electric motor vehicles for the transport of people</li> <li>• Electric motorcycles and bicycles up to 50 UVT</li> </ul>	<ul style="list-style-type: none"> <li>• Mobile cell phone services (currently taxed under the national consumption tax at the rate of 4%)</li> <li>• Gasoline and diesel</li> <li>• Brandy and rum</li> <li>• Table chocolate</li> <li>• Sugar</li> <li>• Wines and cider</li> <li>• Whisky, brandy, vodka and their concentrates, creams and other beverages</li> </ul>	<ul style="list-style-type: none"> <li>• Wheat or meslin flour and other cereals</li> <li>• Uncooked pasta, pasta with egg and others</li> <li>• All types of coffee products</li> <li>• Farm equipment, storage of agricultural products</li> <li>• Preparations used in animal feed</li> </ul>	

Source: DIAN and Ministry of Finance officials.

**Category II:** taxing fossil fuels at a reduced VAT rate on supplies made by fuel producers goes against environmental objectives. Reducing VAT rates selectively for energy products counteracts the intention to increase the relative end-user prices of energy (for environmental or for revenue raising reasons) (OECD, 2015). As previously discussed, VAT should apply to all fuels, consumed by both intermediaries and individuals. In addition, excise taxes should be levied on fuels that generate negative environmental externalities. Applying the standard VAT rate, as currently is the case for the fuel consumed by final consumers, is good practice and this approach should be extended to all fuels, including the supplies made by fuel producers, in order to ensure that all fuel is taxed including fuel that is used in the production of excluded and exempt items. The reason for including these items in category II is their relevance in terms of negative environmental externalities.

The consumption of tobacco, alcoholic beverages and sugar-sweetened beverages generates negative health externalities. These goods should therefore be excluded from the list of products that benefit from preferential VAT treatment. The preferential tax treatment of the consumption of these goods goes against health objectives and comes at a significant tax revenue cost. For instance, the revenue forgone from VAT reduced rates on alcoholic beverages amounted to COP 372 thousand million (approximately USD 100 million) in 2019 according to MFMP 2020. Therefore, cigarettes, alcohol and products that are high in sugar content should be taxed at the standard VAT rate, and be taxed with excise duties to internalise their negative external effects. Evidence from Brazil on cigarettes shows that increasing taxes raises revenues despite the usual concerns on increased smuggling (Iglesias, 2016).

Nevertheless, the taxation of these items in Colombia is complex, as there are different national and subnational taxes that apply, and which cannot be evaluated in isolation. Excise duties are levied on alcoholic beverages, tobacco and luxury goods. The preferential 5% VAT rate for alcoholic beverages, for example, cannot be seen in isolation from the fact that wine and other alcoholic beverages are also taxed under other national and territorial levies. In 2016, the Colombian Congress rejected a proposal on imposing a special excise duty on sugar-sweetened beverages. But while an in-depth evaluation of health excise duties in Colombia goes beyond the scope of this report, there is merit in carrying out a review on this topic as part of the follow-up to the Commission.

### 3.4 TI and TE discussion on an item-by-item basis

#### Basket of basic goods

Efforts to broaden the VAT base and in particular expand it to the basket of basic goods, have been deterred due to the legal precedent set by the Constitutional Court as well as significant political and distributional concerns. The basket of basic goods consists of items that are required to satisfy the "right to subsistence", though what these goods are is not absolute and can be modified over time. In part because the Constitutional Court ruled that taxing the consumption of all these goods would be in contradiction of the minimum living standard, the goods and services within the basket are generally either excluded or exempt from the VAT.

If successfully implemented, the VAT compensation mechanism may alleviate many of the distributional and constitutional concerns of expanding the VAT base to the basket of basic goods and could therefore present an opportunity for reform. If that isn't feasible in the short run, an intermediate step should be to ensure that all of the items in the base basket of goods are at a minimum VAT-exempt and not excluded, in order to broaden the scope and reduce distortions. An improved VAT regime could be based around broadening the base significantly, maintaining a low or 0% reduced VAT rate on the basic needs basket of goods that are required to satisfy the right to subsistence and replacing all preferential rates by one unified preferential rate in the range of 10-12% for instance. Once the VAT compensation mechanism is then able to reach all the poor, the VAT base broadening can then continue by bringing also the basic goods within the standard VAT rate.

As previously discussed, items listed in [Category III](#) could be taxed at the standard VAT rate, but this is conditional upon the roll-out of the VAT compensation mechanism. Farm equipment can be taxed at the standard VAT rate when the agricultural sector is brought within the regular VAT system.

#### VAT on investment in fixed assets

Colombia levies VAT on investment in fixed assets as is common practice in other OECD countries. However, it does not allow businesses to credit the input VAT against the VAT levied on its sales. This is uncommon and distortive as it turns the VAT into a cost on investment. Prior OECD analysis has found that the VAT strongly increases the cost of capital for businesses in Colombia (OECD, 2015). The government has recognised this weakness in the design of the VAT and has recently introduced a CIT credit that is equal to the VAT paid on investment.

The CIT credit for VAT on investment is sub-optimal as it is only partially recoverable. Indeed, the CIT credit for the VAT paid on fixed assets and the CIT credit for 50% of the municipal business turnover tax (100% as from 2022 onwards) can only be claimed by businesses that are profitable and have sufficiently high CIT liabilities. This fear is assuaged to some degree as the un-utilised tax credits can be carried forward to offset CIT liabilities in subsequent taxable years. However, if the CIT credit for the VAT and ICA cannot be claimed in the year when these tax liabilities have been incurred, they will continue to increase the cost of capital and discourage investment.

Firms may have to use the credit over different years, as there is a minimum corporate income tax firms have to pay. Indeed, according to DIAN, while in 2019 COP 6 000 thousand million was paid in VAT on investment, only COP 1 500 thousand million was returned through the CIT credit. This indicates that the VAT on investment remains a significant burden for businesses. The best strategy would be for Colombia to tackle the VAT design flaws at source by having VAT on investment credited within the VAT, rather than addressing them indirectly through the CIT. In addition, the sale of fixed assets should be also subject to VAT.

However, as long as the VAT design remains unchanged, it is important that the CIT credit stays in place. The VAT reform that will provide businesses with a VAT credit for the input VAT paid on investment in fixed assets will need to be accompanied with transitional rules. Businesses that have un-utilised CIT credits corresponding to VAT paid on investment in fixed assets that took place prior to the VAT reform should maintain the right to use these credits to reduce their CIT liability, while VAT paid on new investment should be credited against output VAT levied on sales. One interesting option to explore is whether the VAT on investment can be credited gradually over time from VAT on outputs, for instance over a 3-year period, rather than in the year when the investment took place. Ideally, government would compensate businesses for the delay in refund by paying an interest rate on the deferred VAT credit. This might reduce the impact on tax revenues in the year when the VAT reform is made. Over time, Colombia could then move towards a regime that provides for the immediate refund of the VAT paid on investment, as in other OECD countries.

### **Maintain a VAT reduced rate or move towards a single VAT rate?**

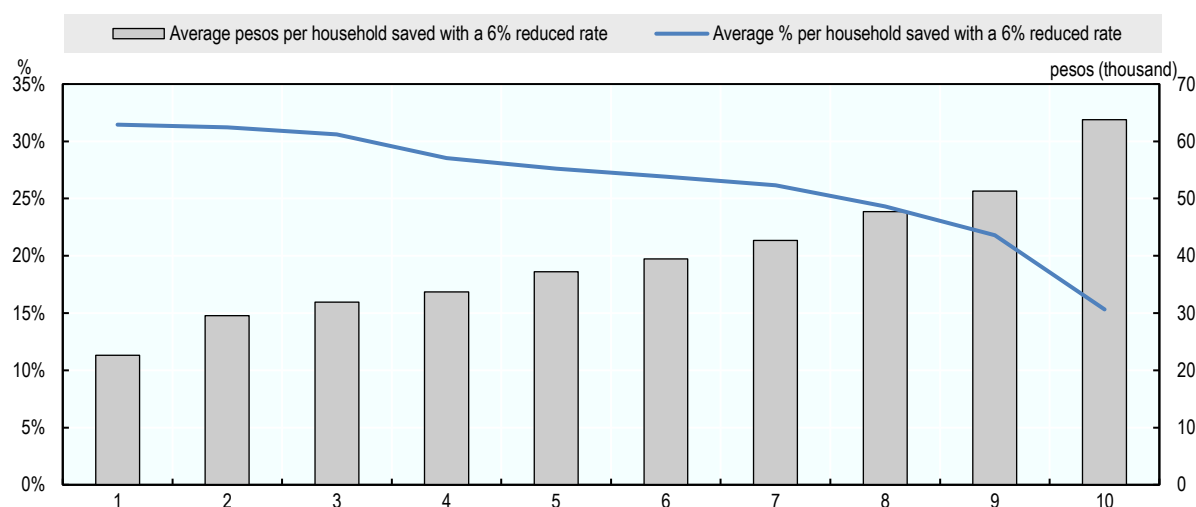
The standard VAT rate in Colombia is 19%, which is not particularly low by international standards. In addition to its 0% rate (including on exports), Colombia also levies a VAT reduced rate of 5%. In general, there are strong efficiency and equity arguments to tax all goods and services at the standard VAT rate rather than levying a reduced rate of 5% (except for exports), and to compensate poor households for the VAT paid through direct cash transfers. In addition to creating distortions, richer households benefit more from reduced VAT rates than poorer households (see Figure 3.6).

The introduction of a VAT compensation mechanism, which is a transfer of cash to low income households for the VAT they paid (see below), is therefore very much welcomed by the Commission. This poses a challenge because Colombia has many very low-income households who cannot afford to pay VAT. In fact, the argument is one of “affordability” rather than whether or not the VAT is “regressive or progressive”.

The Tax Incentives Commission therefore holds the view that, if the VAT compensation mechanism cannot be fully installed in the short run, the 0% reduced VAT rate can be maintained on a selection of items including (in addition to exports) the goods in the basket of basic needs to satisfy the right to subsistence. The reduced VAT rate can be maintained, although the scope of the items that are taxed under the reduced rate can be narrowed. On the other hand, certain items that are currently excluded and exempted can be brought within the scope of the reduced VAT rate if it is not feasible to tax them at the standard VAT rate. Moreover, the reduced VAT rate can be increased to a rate within the range of 10% to 12%. This is particularly important for items that are currently taxed at a reduced VAT rate, including sugar, alcohol and gasoline and diesel. Increasing the reduced VAT rate to a rate that is more aligned with the standard VAT rate would reduce the number of businesses that are in an excess credit position (i.e. for whom the input VAT paid exceeds the output VAT collected) and would reduce opportunities for VAT fraud. In order to avoid further complexity, Colombia should definitely not introduce an additional VAT reduced rate.

Local governments in Colombia are entitled to tax certain items with their own indirect tax. This has induced central government to tax these items at the reduced rather than at the standard VAT rate. Alternative approaches could be considered, including transferring part of the VAT revenues from general government to local governments. Evaluating whether this approach would be worth implementing goes beyond the scope of this report. Nevertheless, a review should be carried out as a follow-up project to the Commission’s work and could form part of a broader review into strengthening the financing of local governments.

### **Figure 3.6: Amount saved from reduced VAT rate per income decile**



Notes: The income decile is represented on the x-axis

Source: DIAN and Ministry of Finance.

### 3.5 VAT compensation mechanism

Income inequality in Colombia has been shown to remain broadly unaltered by the tax and transfer system (OECD, 2020<sup>[4]</sup>). In this context and as part of the so-called “Growth Law” (*Ley de Crecimiento*), passed by the Colombian Congress in 2019, reforms included a VAT compensation mechanism for the poorest households aimed at improving the fairness of the tax system. Specifically, the poorest 20% of the population were to be given a 100% VAT compensation.

The implementation of the VAT compensation mechanism was subsequently brought forward to end-March 2020 as the sanitary crisis placed further pressure on poor households. The programme initially covered 1 million Colombians; 700 000 of the poorest households already receiving poverty alleviation programmes via *Familias en Acción* and 300 000 from the *Colombia Mayor* program. These households receive COP 75 000 every two months, equivalent to 30% of the extreme poverty line and 5% of Colombia’s minimum wage in 2020. According to a recent impact evaluation carried out by academics from New York University and the University of California, Los Angeles, the compensation mechanism had positive, albeit modest, effects on food access, financial health and other measures of household well-being (Londoño-Vélez and Querubín, 2020). The unconditional cash transfer also boosted support for emergency assistance to households and firms during the crisis and promoted social cooperation.

However, the fiscal reform missed the opportunity to improve the overall functioning of the VAT in Colombia. More than half of the VAT revenue potential goes untaxed, as a result of reduced VAT rates, exemptions, sub-optimal tax enforcement and tax evasion. Furthermore, it is the richest households that consume over half of the excluded or reduced rate VAT goods, and who thus capture a large share of this implicit subsidy. This reduces the efficiency of efforts to protect the purchasing power of poor households, costing the state in significant foregone revenues. Previous OECD Economic Surveys have recommended a broadening of the VAT base, accompanied by a cash transfers to low-income households (OECD, 2019<sup>[5]</sup>) to improve the equity and efficiency of the tax and transfer system.

An alternative VAT regime that applies the standard VAT rate to all consumption, while compensating low-income households through cash transfers, has the potential to both increase public revenues and improve the progressivity of the tax and transfer system. This VAT compensation mechanism could give renewed impetus to the government’s efforts to broaden the VAT base by reducing the number of exceptions, exemptions and reduced rates, in particular those that are most distortive and least effective in supporting

the poor. Indeed, the Government's communication about the cash transfer programme to compensate poor households for their VAT payments might create a window of opportunity for future VAT base broadening reform.

Tax compensation via transfer payments requires higher digitalisation of payments, banking penetration and better control capacity than currently exists in Colombia. For this reason, the government has been using existing social programmes such as *Familias en Acción* and *Colombia Mayor* to deliver the VAT compensation. However, households receive the transfer independently of the taxes they pay and therefore receive the average amount of VAT paid by poor households. Consequently, current transfers augmented by the VAT compensation will enable more effective targeting of specific groups than tax rebates or differential VAT rates, further contributing to the positive effects on equity and poverty reduction that these programmes have.

According to the Ministry of Finance, strong progress has been made in targeting (i.e. identifying and ranking) poor households through SISBEN.<sup>18</sup> Expanding coverage of social transfers such as *Familias en Acción* and *Colombia Mayor*, particularly in rural areas, and increasing the level of cash transfers through the VAT compensation programme could help reduce poverty and inequality further.

The VAT compensation is also an opportunity for improving access to banking and basic payment services for vulnerable households. The existing cost of delivering *Familias en Acción* could be reduced by defining a universal service/basic package of banking services for low-income households that would include the delivery of the social benefit, the ability to spend it through a debit payment card in addition to cash withdrawals and basic remote banking through cell phones, to ensure access to those in remote areas without physical bank branches in the proximity. Adding a basic savings account with non-negative real interest rates would also be useful to strengthen saving incentives, even if pick-up is likely to be slow. The great challenge is to bring the informal population and migrants into the banking system, for whom a major effort must be made in terms of opening simplified accounts and other instruments such as electronic wallets, through Fintech companies.

The base broadening of the VAT implied by the aforementioned regime will, however, increase the amount of VAT paid by the poor. According to Ministry of Finance and DIAN simulations of household VAT expenditures, the average amount of VAT paid by households in the second income decile would be approximately COP 100 000 per month in a scenario where essential goods remain excluded while other goods and services that were previously excluded and exempt (including basic good basket items) are taxed at a 19% rate. If this were to become the amount of VAT compensation given to around five million households in the first four income deciles, the total cost of the scheme would be 0.5% of GDP. This is significantly higher than the 480 thousand million peso cost of the VAT compensation scheme in 2020, which only transfers COP 37 000 a month to one million households. The amount of VAT compensation will have to be recalculated if the medium term policy recommendation included in this report is adopted

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<sup>18</sup> Colombia targets social programs such as *Familias en Acción* and *Colombia Mayor* using the identification system of potential beneficiaries SISBEN. SISBEN's objective is to classify the population according to their socio-economic conditions, making it possible to identify the potential beneficiaries of the State's offer of social programs. For this purpose, SISBEN staff visit households and request the completion of the survey. The National Planning Department (DNP) compiles the information collected in a single database. Beyond the database's administration, DNP is in charge of applying the corresponding models to classify the population according to their socio-economic status. With this information, different government programs can target their beneficiaries and meet their objectives. The fourth version of SISBEN is currently in development. In June 2020, SISBEN IV had 11.6 million people classified in groups corresponding to extreme poverty and moderate poverty. In this sense, SISBEN IV had a coverage close to 66% of the 17.5 million people living in poverty in the country for 2019, according to data reported by DANE. The system is rapidly expanding; by January 2021, its coverage of people living in poverty increased eight p.p., rising to 74% (12.9 million people). The National Planning Department (DNP) expects the coverage of poor people to be close to 80% in March 2021 and higher than 90% at the end of this year. To the extent that group A (extreme poverty) has 4.5 million people, which represents 96% of the total number of people in extreme poverty estimated for 2019 by DANE (4.7 million), efforts to the expansion of SISBEN IV during 2021 will focus mainly on group B (moderate poverty).

(i.e. eliminate the VAT exclusions and exemptions except for exports and the basket of basic needs goods and increasing the VAT reduced rate to within a range of 10% to 12%).

The revenues necessary to compensate the poor will change over time depending on the level of transfer payment chosen and any expansion in the eligibility criteria of those households that are defined as being poor. While a base broadening tax reform should enable growth in government tax receipts, growing social spending and infrastructure needs will put pressure on tax revenues that are currently low in international comparison, making the achievement of medium-term fiscal rules challenging.

Identifying the correct amount of VAT compensation can also be challenging for a number of reasons. The VAT compensation should reflect the spending of poor households, but consumption habits will undoubtedly vary across households potentially favouring some over others. VAT can also be imbedded in price levels as a result of VAT exemptions and VAT cascading. Moreover, many poor households will have a high propensity to buy goods in the informal economy, where no VAT is levied. This latter point may be somewhat offset by the cascading effect of VAT being applied to products at each step of the value chain.

### 3.6 National Consumption tax

In addition to VAT and excise duties, Colombia also levies a “National Consumption Tax” on a selected number of items. The National Consumption Tax is not a VAT, but a sales tax instead. In general, sales taxes are distortive as they are levied each time a transaction is made. This results in tax cascading (i.e. sales tax is levied on sales tax), which does not occur under the VAT. The National Consumption Tax is levied on a number of “luxury” goods and it replaces the VAT in some sectors, such as restaurants that operate largely in the informal economy. Some members of Congress have recently suggested abolishing the VAT and replacing it with the National Consumption Tax. Such a reform would be a mistake. Instead, the Tax Incentives Commission suggests evaluating (as part of a follow-up project) whether the National Consumption Tax could be abolished, as its role can be played by the VAT and excise duties instead.

The National Consumption Tax is partly levied on luxury items, including cell phones and expensive cars. Some of the items that are taxed under the National Consumption Tax receive preferential VAT treatment and are thus not taxed at the standard VAT rate. This report recommends strengthening the design of the VAT and taxing more goods and services at the standard VAT rate. This approach would no longer require levying a separate National Consumption Tax. The National Consumption Tax can also interact negatively with environmental objectives, as it is levied on electric cars, for example, which are typically expensive. Instead of levying the National Consumption Tax, all vehicles should be taxed at the standard VAT rate and this tax should be complemented with excise duties that are increasing in the CO<sub>2</sub> that the car emits. Overall, the Consumption Tax can be replaced with different excise duties. While taxing luxury items can bring some progressivity into the tax system, the Tax Incentives Commission holds the view that tax progressivity should be strengthened through improving the design of the Colombian PIT.

The National Consumption Tax is also levied on restaurants that, in the past, were not VAT compliant. Many small restaurants did not charge VAT on their sales and did not incur VAT on their inputs, as these inputs were bought from the informal economy. In light of the sector’s weak tax compliance, government decided to submit the sector to the National Consumption Tax instead. This reform created its own distortions for restaurants that, for example, work under a franchise. Upon request from this sub-sector, franchise restaurants were reintegrated within the VAT. Nevertheless, the current approach used to tackle the informal sector remains sub-optimal, and government has better tax instruments to deal with this issue. First, small restaurants remain below the VAT registration threshold so they are not obliged to charge VAT. Second, restaurants can be brought within the reach of SIMPLE, which will lower the income tax liability that small restaurants will have to pay. Services provided by restaurants could be taxed at the reduced VAT rate. Such a reform would then allow simplifying the system and abolishing the National Consumption Tax.

### 3.7 Excise duties

Excises, unlike other general consumption taxes, including VAT are levied only on specific goods. Unlike VAT, which is collected through a staged collection process by all the stakeholders in the value chain until the final consumer, excise duties are normally collected only once, from one registered operator, at the time the goods are released for consumption (OECD, 2018). Health taxes are generally levied in the form of excise duties. Health taxes are levied on goods that adversely affect health such as tobacco, alcohol and sugar sweetened beverages. They can be levied directly at the component that creates negative health effects (e.g. alcohol, sugar in excess) or on the product that contains the component that is harmful for consumer health.

An often-cited concern in implementing health taxes is their potential distributional impact. In particular, poorer households may have more unhealthy lifestyles and spend a greater proportion of their current income on products subject to health taxes than richer households do. However, this may not necessarily be the case as a percentage of their current expenditure (OECD/KIPF, 2014<sup>[6]</sup>).

Even when the poor do bear a greater tax burden than the rich, they can still be expected to benefit more from improvements in health outcomes. To evaluate who benefits or is disadvantaged by health taxes it is necessary to evaluate not only which income groups will bear the higher tax burden but also which households will benefit the most from a reduction in negative health outcomes (Gruber and Koszegi, 2004<sup>[7]</sup>); (Allcott, Lockwood and Taubinsky, 2019<sup>[8]</sup>). If low-income consumers are more responsive to after-tax price changes of unhealthy consumption items, then the corrective benefits are large relative to the financial burden, making the regressivity of the tax less of a concern (Fuchs, González Icaza and Paz, 2019<sup>[10]</sup>). Progressive health gains can be expected because smoking and consumption of SSBs cause diseases that disproportionately affect low-income households (Mytton, Clarke and Rayner, 2012<sup>[11]</sup>).

Moreover, the progressivity of the tax and benefit system has to be analysed as a whole and the distributional consequences of tax mix shifts should be examined in concert with the public spending mix. A regressive health tax can still lead to an overall progressive outcome if its revenues are spent particularly on the poor (also referred to as progressive revenue recycling).

Research on the distributional impact of excise taxes on transport fuels has shown that these taxes are not regressive as a whole. The non-regressive nature of taxes on transport fuels can be explained both by a smaller likelihood of lower income households owning a car and by driving less if they own a car (Flues and Thomas, 2015).

### 3.8 Conclusions and options for reform

Colombia's VAT grossly under-performs against its objectives. It is littered with an array of VAT exclusions, exemptions and the reduced rate has a wide scope. The country's VAT revenue ratio – a universally used indicator to measure the size of the VAT base<sup>19</sup> – is one of the lowest among both OECD and Latin American countries. Put alternatively, Colombia's VAT revenue forgone as a percentage of GDP is the fourth largest of all Latin American countries. This narrow base has wide ranging consequences including significant foregone tax revenues, a plethora of distortions to the functioning of the market economy and investment decisions and difficulties in ensuring poorer households are not disproportionately impacted by taxes on consumption. Not only this, the wide range of exclusions, exemptions and reduced rates also increase the complexity of the tax regime, providing both tax avoidance opportunities for those able to exploit loopholes and increasing DIAN's costs in both administering the tax and ensuring compliance.

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<sup>19</sup> Defined as the ratio between the actual value-added tax (VAT) revenue collected and the revenue that would theoretically be raised if VAT was applied at the standard rate to all final consumption



This under-performance cannot be seen in isolation from the country's large informal sector, however. The widespread informality seen throughout the Colombian economy puts VAT revenues under pressure, as businesses and households sell to and buy from the informal sector. Furthermore, some elements of the VAT's design, such as the non-recoverable VAT paid on fixed assets, encourages businesses to operate in the informal sector (and abroad) in order to avoid elevated costs on investment.

There have been a significant number of reforms to Colombia's VAT regime over the last few years, which can be seen as a step in the right direction. In particular, the move towards a CIT credit for input VAT on investment has somewhat helped to reduce the cost of investment, and the introduction of a VAT compensation mechanism in early 2020 (taking advantage of the opportunity presented by the pandemic) has generated momentum for a broadening of the VAT base.

The VAT compensation mechanism is rightly ambitious in its scope and objectives. According to DNP officials, the entity is ready to overcome the challenges in the short run and will be able to identify over 90% of the poor by the end of 2021. Compensating all low-income households will necessitate improvements in targeting, extending coverage beyond those that are, or have been part of the government's conditional cash transfer programs, and finding ways to integrate poor households without bank accounts. The amount of VAT compensation will have to be recalculated if the medium term policy recommendation included in this report is adopted.

The existing issues with Colombia's VAT regime do not warrant a replacement of the VAT with a sales tax. Rather, the Tax Incentives Commission strongly recommends improving the design and functioning of the VAT regime. A core element of such a reform would be based around VAT base broadening and reducing tax complexity. Exemptions, exclusions and reduced rates should be limited as much as possible. The 0% reduced VAT rate can be maintained on a selection of items, including exports and the basket of basic needs in order to satisfy the right to subsistence. Over time, when the amount of VAT compensation is increased accordingly, the basic good items can be taxed at a higher rate.

The government could progressively eliminate the VAT exclusions and exemptions – in particular the ones that are uncommon from an international perspective – and steadily increase the number of items that are taxed at the standard VAT rate of 19%. Colombia should implement a single reduced VAT rate, although the scope of the items that are currently taxed at the reduced rate can be narrowed. On the other hand, certain items that are currently excluded and exempted can be brought within the scope of the reduced VAT rate if it is not feasible to tax them immediately at the standard VAT rate. Moreover, the reduced VAT rate can be increased to a rate within the range of 10% to 12% to avoid a situation whereby too many businesses are in an excess VAT credit position and to limit VAT fraud. Increasing the reduced VAT rate is also warranted in light of the items that are currently taxed at the reduced rate, such as sugar, alcohol, gasoline and diesel. The standard VAT rate of 19% should not be increased, as the rate is not particularly low by international comparison.

The design of the VAT should be improved so that businesses can receive a timely refund for the VAT paid on investment in fixed assets. Although the CIT credit for the input VAT on investment is an improvement as it avoids the VAT from increasing the cost of capital for profit-making businesses, it is suboptimal. Tackling the VAT design flaws at source, that is, having VAT on investment credited within the VAT, is a better strategy than addressing them indirectly through the CIT. Nevertheless, as long as the VAT design is not changed, it is important that the CIT credit remains in place. One interesting option to explore is whether the VAT on investment can be credited gradually over time from VAT levied on sales (for instance over a 3-year period) rather than in the year when the investment took place.

Over time, the National Consumption Tax should be abolished and the design of health and environmentally related excise duties should be improved. There are numerous examples of "low-hanging fruit" that could be rectified almost immediately, one example being VAT exemptions on magazines. Other

reforms, such as the interaction of the different indirect taxes as a way to finance local governments, might require more preparation but are important to address.

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# 4

## Working Party 2: Corporate Income Tax

Tax Expenditures Report



## 4. Working Party 2: Corporate Income Tax

*Rather than introducing “marginal” reforms, Colombia needs a fundamental overhaul of its business tax system that broadens the tax base and simplifies the tax system. The reform should align the tax treatment across sectors; abolish the distortive non-profit based taxes including the equity or wealth tax; turn the financial transaction tax into a tax on cash withdrawals only (or abolish it entirely); eradicate the CIT recapture tax and lower the standard CIT rate significantly for all businesses. The current tax regime has so many TEs and loopholes that eliminating only some may not lead to significantly more tax revenues as businesses will just make use of the next-best TE to reduce their tax liability. Colombia’s distortive business tax system has induced Congress to introduce an excessive number of tax incentives. This has further increased tax complexity, tax enforcement costs, and tax avoidance opportunities. At the same time, it has also reduced revenues, which leads to more calls for higher tax rates and new tax incentives. The tax system is stuck in a continuous cycle where increased complexity breeds further distortions and inequity, which again lead to more complexity. Colombia should break out of this vicious cycle of complexity. Rather than tackling distortions through the introduction of tax incentives, Colombia should resolve the challenges at source by designing a CIT regime that is competitive for all sectors. Over the last couple of years, Colombia has introduced tax measures that have made the standard business tax regime more competitive. This process should continue as large distortions and inequities within the business tax regime remain prevalent. The standard business tax regime is complemented with SIMPLE, which is a presumptive business tax regime for small businesses. The stated objective of SIMPLE is to incentive businesses to enter the formal economy and to ensure that their workers have access to health and pension entitlements; this approach is very much welcomed. Nevertheless, there is room to improve the design of SIMPLE and to ensure that all small businesses across all sectors fall under its scope and are encouraged to formalise via the regime. Making the fundamental business tax reform Colombia needs will require a complete change in the mindset of Colombian policymakers and legislators, who must stop over using the tax system to tackle problems that are beyond its scope. Unfortunately, the 2020 reform, which included preferential tax treatment for the tourism sector and businesses that hire young workers, demonstrates the tendency of these policymakers and legislators to favour new tax incentives over genuine reform that reduces distortions and reinstalls fairness.*

### 4.1 Introduction

This note identifies the tax expenditures (TEs) within the corporate income tax (CIT). TEs are defined as tax provisions that deviate from a benchmark tax system; tax incentives are part of the broader category of TEs. It should be noted the CIT also has a number of general CIT base reductions (*minoraciones estructurales*)<sup>20</sup> which do not qualify as TEs as they are considered to be inherent to any tax system and are not intended to give preferential treatment to certain subjects or activities. This chapter does not restrict itself to tax incentives, but lists all tax provisions that are, or could be, considered as TEs within the CIT. This chapter also discusses whether there is scope to broaden the CIT base by reforming the TEs on an item-by-item basis.

Figure 4.1 presents the scheme that has to be followed for determining final CIT liability. It also identifies the main types of TEs that apply within the CIT: “non-taxable income”, “deductible expenses”, “exempt income”, “tax credits” and “reduced tax rates” (see Table 4.1). The distinction between “non-taxable

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<sup>20</sup> This notion has been widely developed by the Constitutional Court and DIAN’s legal office, in order to state that there are some reductions that are applied over the CIT base that do not correspond to a TE. Since they are general deductions applicable to any taxpayer, the purpose of those reductions is not to promote or prefer a certain subject or economic activity for extra fiscal purposes, but to adapt the CIT burden of the taxpayer under equity criteria.

income” and “exempt income” is Colombia-specific and was relevant for the functioning of the presumptive tax before that tax was abolished.

**Figure 4.1: From gross revenues to final CIT liability in Colombia**

	<b>Gross Revenue</b>
–	Discounts, returns and rebates
	<b>Net revenue</b>
–	Non-taxable income
	<b>Taxable net revenue</b>
–	Deductible expenses
	<b>Taxable income</b>
–	Exempt income
	<b>Net taxable income</b>
x	<b>Tax rate</b>
	<b>Basic income tax</b>
–	Tax credits
	<b>CIT liability</b>

Source: DIAN

Some sectors, however, have special provisions for the determination of their taxable income, such as the financial sector, the oil, gas and mining sector, the international transport sector, gas stations, leasing companies, insurance companies, bookshops and construction services. Concessions also receive a special tax treatment. See Annex for further information.

In addition to the CIT, businesses need to pay a wide range of other taxes that might have an impact on the cost of capital and the effective tax burden that business face. Some of these additional taxes have been (partly) offset through the introduction of TEs, as will be discussed below.

- **VAT on fixed assets:** VAT has to be paid on investment in fixed assets, but businesses cannot obtain a refund against output VAT for the input VAT paid on the investment. As from 2019 onwards, the unrecoverable VAT can be recovered in the form of a CIT credit.<sup>21</sup>
- **Equity tax:** a tax imposed for 2020 and 2021 that is levied on non-resident businesses that are not subject to file an income tax return in Colombia and individuals with equity above COP 5 thousand million (about USD 1.3 million). Colombian tax-resident businesses are not subject to the equity tax. The tax is levied at a rate of 1% on the value of the assets owned in Colombia.
- **Industry and Commerce Tax (ICA):** a municipal tax levied on business turnover; the rates vary depending on the company’s activity and municipality. The tax effectively paid is a 100% deductible expense or 50% (100% as of 2022) tax credit for CIT purposes. For Bogota, the rates vary between 0.414% and 1.38%. For other municipalities, the rates range between 0.2% and 1%.
- **Debit tax:** financial transaction tax levied on the amount of each financial transaction, such as disposals of funds from savings accounts, current bank accounts and deposit accounts, which

<sup>21</sup> Businesses that produce goods or services that are VAT excluded continue to deduct VAT following the tax depreciation of goods in their income tax returns. While the depreciation of the VAT cost does help somewhat, it does not fully neutralise the impact of the VAT on investment on the cost of capital, which remains significantly above the cost of capital that businesses would face in case of a neutral design of the VAT.

involve cash withdrawals by checks and through other mechanisms, and on the amount of certain accounting entries. The tax is levied at a rate of 0.4%. Half (50%) of the tax paid can be deducted from taxable corporate profits. There are certain transactions that are exempt from debit tax, however, in accordance with section 879 of the Colombian Tax Code.

- **Recurrent tax on business property:** municipal tax levied on the ownership of land or businesses' immovable property; the tax rate is applied to the self-assessed value, which may differ from the commercial value, of the property. The rate is set by the municipality and varies between 0.1% and 3.3% according to the location and use of the property.

Employers have to pay social security contributions (SSCs) on behalf of their employees, either in the form of employee SSCs or employer SSCs. These SSCs are not listed as taxes that increase the tax burden on businesses, as the incidence of the SSCs is assumed to fall on workers and not on the businesses, as illustrated by extensive empirical research (Brittain, 1971; Ooghe 2003), particularly where tax-benefit linkages are strong (Bozio et al., 2020).

## 4.2 CIT Tax Expenditures in Colombia

### 4.2.1 Overview of the main CIT Tax Expenditures

Colombia has a wide range of tax provisions that deviate from the benchmark tax system. This section lists a number of the most important tax incentives and tax expenditures, and discusses whether there is scope for reform.<sup>22</sup>

#### *Standard rate, reduced rates and surtax rate*

The standard statutory CIT rate is 32% in 2020, which will be reduced to 31% in 2021 and to 30% as of 2022 onwards. Table 4.1 provides an overview of all the reduced CIT rates that apply. Financial institutions with taxable income greater than 120 000 UVT (approximately COP 4 thousand million or USD 1 million) are subject to a CIT surtax of 4% in 2020, which will be lowered to 3% for 2021 and 2022.

**Table 4.1 Special CIT rates**

CIT Regime	Tax rate
FTZs	20%
Stability contracts <sup>(1)</sup>	15%
New Free trade zones Cucuta	15%
Mega-investments	27%
Industrial and commercial state companies, publishing companies, new hotels and/or renovated hotels, theme parks, ecotourism parks, agro-tourism and nautical docks <sup>(2)</sup>	9%
Financial institutions surtax	4%
Small and microenterprises ZOMAC <sup>(3)</sup>	0%
Medium and large ZOMAC <sup>(4)</sup>	16%
First 5 years ZESE	0%
6-10 years ZESE	half of the standard CIT rate

<sup>22</sup> A full list of all tax incentives and expenditures pertaining to the CIT is available in the annex of this chapter. Importance is judged against a number of criteria, including the value of foregone revenue, distortive and distributional impact, and complexity.

Notes: (1) Not all stability contracts grant a 15% rate; each agreement is different and can grant different CIT rates. For example, the 15% rate was granted for FTZ users with stability contracts and users of new FTZ established between 2017 and 2019 in the Municipality of Cúcuta. Under the mega-investment regime, taxpayers can enter into stability contracts in order to “stabilize” the tax rate. (2) This also includes the mixed economy companies of the Departmental, Municipal and District order, in which the participation of the State is greater than 90% exercised by the monopolies of lotteries and of liquors and alcohols. (3) 0% from 2017 to 2021, 25% of the standard CIT rate from 2022 to 2024, 50% of the standard CIT rate from 2025 to 2027 and the standard CIT rate from 2028 onwards (cf. article 237 of Law 1819 of 2016). 50% of the standard CIT rate from 2017 to 2021, 75% of the standard CIT rate from 2022 to 2027 and the standard CIT rate from 2028 onwards (cf. article 237 of Law 1819 of 2016).

Source: DIAN

## Special tax regimes

**Non-profit organisations**: Profits made by qualifying non-profit entities are CIT exempt if the surplus is spent directly or indirectly on the entity’s social purpose in the following year or following years when certain requirements are met.<sup>23</sup> Surpluses that are not invested or allocated in the development of the non-profit organisation’s “worthy purpose” are subject to a 20% CIT rate.

**Free Trade Zones**: this regime is discussed as part of WP5’s tax policy note.

**ZOMAC and ZESE**: these regimes are discussed as part of WP3’s tax policy note.

**Mega-investments**: Under article 1.2.1.28.1.1 of Decree 1625 of 2016, taxpayers may benefit from a number of tax advantages if they fulfil the following criteria: (i) they generate at least 400 new direct jobs, or at least 250 new direct jobs from mega investments made in sectors with a high technological component, or in sectors of emerging and exponential technologies, including e-commerce; (ii) make new investments within the national territory with a value equal to or greater than UVT 30 million in any industrial, commercial and/or service activity, or UVT 2 million when the investment corresponds to the national aeronautical sector (decree 575 of 2020). If these criteria are met, the following tax benefits apply: i) CIT rate of 27% or 9% for hotels; ii) depreciation of fixed assets within 2 years; and iii) exoneration from the presumptive income tax rules and the business wealth tax (but both have been reformed recently so that they no longer provide a tax incentive to mega-investments but apply to all investments and businesses). Additionally, if investments are made through domestic companies or permanent establishments, the profits they distribute will not be subject to the dividend tax. When the dividends correspond to profits taxed at the corporate level they will be subject to the rate of 27%, in accordance with the rules of articles 48 and 49 of the CTC (cf. article 235-3 of the CTC). See Chapter 5 (WP3) for a more detailed discussion on the taxation of dividends.

**Colombian Holding Companies (CHC)**: this regime applies to Colombian companies whose main business activities are the holding of securities, investment or holding of shares or participations in Colombian and/or foreign companies or entities, and/ or the management of these investments. A number of conditions have to be met, including that the company needs to hold at least 10% of the capital of two or more Colombian or foreign entities during at least 12 months, have three or more employees and needs to be recognised by the Tax Authority. The tax incentives are significant, including:

- Dividends distributed by non-resident entities to a CHC are CIT exempt. Further distribution of such dividends by the CHC to tax residents in Colombia is subject to the dividends tax (but not to the dividend withholding tax that is levied at a rate equal to the CIT rate), unless the dividends are distributed to a non-tax resident agent.

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<sup>23</sup> Members of the CIT Working Party signalled that the rules are abused and that there is large tax fraud, in particular by businesses that disguise themselves as “not-for-profit businesses” but in reality are profit making. An in-depth review of the sector should be carried out as a follow-up project to the TIC report.



- Income derived from the sale or transfer of the participation of a CHC in non-Colombian entities is capital gains tax exempted.
- Income derived from the sale of shares or participations of a CHC is tax-exempt, except for the portion corresponding to the profits derived from activities carried out in Colombia.

### Stability contracts

In the past, the Colombian government provided “stability contracts” to certain types of businesses (Law 963 of 2005). These contracts provided tax certainty to businesses, who identified the tax regulations of their interest, so that they would not be affected by modifications to legislation, and often included targeted tax incentives such as a reduced CIT rate. These types of contracts are thought to be needed because of the complexity of the tax regime and the frequency of tax reforms, which may discourage foreign businesses from investing in Colombia. However, a substantial disadvantage of stability contracts is that they only provide preferential tax treatment to a selection of businesses, which creates incentives for lobbying and possibilities for corruption. This Commission consistently calls for a fundamental change in the way Colombia carries out tax reform, ending the use of sub-optimal tools and tax incentives targeted at only a selection of businesses. Indeed, the aim should be to provide tax certainty to all businesses. The Tax Incentives Commission endorses the government’s decision to stop using stability contracts and stresses that its approach should not be reversed.

### Double tax treaties

Most OECD countries treat double tax treaties as being part of the tax benchmark and they, therefore, do not give rise to TEs. The foreign tax credit for taxes paid abroad by resident taxpayers earning income from a foreign source would therefore not be a TE. However, Colombia has not defined a TE benchmark, which is why some members of the CIT Working Party hold the view - in contrast to common practice in other OECD countries that operate a worldwide tax system - that the foreign tax credit is a form of TE.

Tax treaty policy is a separate subject that should be studied independently from domestic tax laws. However, participants of the CIT Working Party signalled weaknesses in the current design of tax treaties in Colombia and indicated that they may give rise to large profit shifting opportunities and that, implicitly, the tax treaties include tax incentives. The Tax Incentives Commission suggests that the design and functioning of the Colombian tax treaties should be evaluated as part of a follow-up project.

### Non-taxable and exempt income

The topic of non-taxable and exempt income will be discussed as part of the tax policy notes of WP3 and WP4; the discussion included here focuses on the most important items in relation to the CIT. A detailed list of these non-taxable and exempt income items can be found in the Annex, however a number of the most important non-taxable and exempt income items is listed below. Since the presumptive income tax regime (AMTI) will no longer be operational from 2021 onwards, the two categories will become equivalent. The Tax Incentives Commission holds the view that Colombia should merge both concepts into one item as part of a tax simplification reform.

#### Non-taxable income:

- [\*Non-substantial sale of shares\*](#): Business profits from the sale of shares registered in the Colombian stock exchange, owned by the same beneficial owner, are non-taxable income when the sale does not exceed 10% of the outstanding shares;
- [\*Non-taxable dividends\*](#): Dividends received by partners, shareholders and the like of domestic companies, when the profits being distributed were already taxed by the company

distributing the dividends (if the conditions of article 48 and 49 of the Colombian tax code are met).

Exempt income:

- [Profits of Orange economy](#): A 7-year tax exemption for income earned by companies engaged in the technological and creative sectors (Orange economy). This tax incentive was introduced in 2019; it applies to companies exclusively engaged in the development of 1 of the 27 business activities defined as the “creative industry”, including jewellery manufacturing; book publishing; film, music, radio and television production; software development; architecture and engineering and other activities related to technical consultancy; theatre and other cultural activities; and cultural tourism activities;
- [Profits of the farming sector](#): A 10-year exemption for income derived from investments, which increase the productivity in the farming sector;
- [Profits from the renewable energy sector](#): A 15-year exemption for income derived from the sale of electrical energy, carried out by generating companies, derived from wind energy, biomass or agricultural, solar, geothermal or marine waste;
- [Profits of certain plantations](#): Income derived from new forestry plantations, including guadua, rubber and cashew, as well as income from plantations of timber trees and fruit trees;
- [Income of pension funds](#): Income earned by pension funds. In accordance with numeral 9 of article 235-2 of the CTC, an exemption is granted over yields generated by the stabilization reserve constituted by the pension and severance fund administrators. Pension and severance funds are not subject to CIT, according to section 23-2 of the CTC;
- [Profits of new hotels](#): A 30-year exemption for income of new hotels that were built within the following 15 years as of the entry into force of Law 788 of 2002. (Repealed by Law 1819 of 2016).
- As this tax incentive has been abolished, it will not be discussed further below (despite the fact that its influence will continue for many years). The example shows that providing generous profit-based tax incentives for a long period constitutes bad tax policy that should be avoided. Note also that the design of the tax incentive does interact with the CIT recapture tax, which does apply for exempted profits but not for 0%-rated profits that are distributed as dividends.

### Deductible costs and expenses

In general, costs incurred to earn taxable business income are deductible; this includes regular financing expenses, necessary expenses and expenses incurred abroad, salaries and payroll taxes, taxes, interests, deductions for the economic depreciation of assets, and losses. These costs and expenses cannot be considered TEs as they are not granted to a specific sector or taxpayer, and are inherent to tax the system.

On the other hand, there are a number of deductible costs/expenses that are less common and that very likely would not be included in the tax benchmark (if Colombia were to define one). These deductions would then be classified as TEs, and the corresponding tax revenue foregone should be included in the Colombian annual TE report. Members of the CIT Working Party also signalled significant tax evasion within family and closely-held corporations that claim private household expenses as business expenses. This tax evasion should be countered by stricter tax enforcement, improved tax auditing tools and increased penalties. The Annex contains a list of items that could be considered as TEs, the most important of which are described below.

- [Financial transaction tax](#): 50% of the financial transaction tax (GMF) can be claimed as a cost;
- [Accelerated tax depreciation allowances](#): Tax depreciation allowances that are not aligned with the economic depreciation of the asset;
- [Business immovable property tax](#): 100% of the recurrent tax on businesses' immovable property is deductible (if the tax has a direct relationship with the production of income);
- [Non-wage expenditure for workers and their families](#): expenditure for workers such as additional health insurance, contributions for private pension savings, and other fringe benefits are deductible from taxable corporate income.

Whether these deductions are CIT TEs will largely depend on how these fringe benefits are taxed under the PIT. If these fringe benefits are taxed at fair market value under the PIT, one might be inclined to conclude that these deductions do not constitute a TE at the CIT level. However, whether or not these deductions are CIT TEs depends on how the CIT benchmark is defined. If Colombia were to define a CIT benchmark with a broad base, then these deductions may end up being identified as a TE, despite the fact that they would not necessarily lead to an "actionable" TE. Indeed, these costs are actual business expenses so it is logical that they remain deductible from taxable profits. However, identifying these deductions as TEs would increase transparency on the amount of fringe benefits that are paid by businesses. In summary, whether or not non-wage expenditure for workers and their families constitutes a CIT TE depends on the design of the PIT and on the definition of the TE benchmark at the CIT level. As Colombia has not defined a TE benchmark, the chapter does focus on these deductions as members of the CIT Working Party have indicated that businesses are using these fringe benefits to remunerate their workers in a way that escapes tax at the PIT level. The future Colombian TE report should therefore focus on these items.

- [Donations](#): Donations to the General Gustavo Matamoros D'Costa Corporation and to foundations and organizations dedicated to the defence, protection and promotion of human rights and access to justice, to amateur sports organizations, sports clubs, sports federations or associations and the Colombian Olympic Committee, and to recreational or cultural organizations are deductible up to 125% of the value of the donation. Certain donations simultaneously grant special deductions and a tax credit, as can be seen in section 125 and 257 of the CTC. Recently, Law 2062 established a new deduction for donations for COVID vaccines.

Tax credits:

- [Credit for VAT on investment in fixed assets](#): VAT on the import, formation, construction or acquisition of real productive fixed assets can be claimed as an income tax credit in the tax year in which they pay the VAT or in any subsequent tax years;
- [Credit for the municipal business turnover tax](#): Taxpayers are entitled to claim 50% of the local turnover tax that they pay as a CIT credit. As of 2022, the tax credit will be 100%;
- [Credit for donations](#): 25% of donations granted to non-profit entities qualified under the CIT special regime and to CIT non-taxpayers as stated in articles 22 and 23 of the Colombian tax code;
- [Other CIT credits](#): The Annex includes a long list of other CIT credits.

#### 4.2.2 Tax provisions that may impact the effectiveness of CIT Incentives

##### CIT recapture tax

Colombia levies a dividend withholding tax at a rate equal to the standard CIT rate (i.e. 32% in 2020, 31% in 2021 and 30% from 2022 onwards) on distributed dividends that have not been subject to CIT. The dividend withholding tax therefore operates as a “CIT recapture tax”, which is the name that we will use in the remainder of the chapter.<sup>24</sup> The scheme in Figure 4.2 is applied to determine the maximum amounts of dividends that can be distributed as “non-taxable income”, which is the Colombian tax terminology used for dividends that have been subject to the CIT, irrespective of the effective CIT rate that has been applied, and therefore do not fall under the CIT recapture tax. Instead, dividends that are classified as “taxable income” refer to dividends that are distributed out of untaxed corporate profits; and these dividends will fall under the CIT recapture tax.

**Figure 4.2 Dividends that can be distributed as non-taxable income**

Operation	Concept
	The taxable base, plus the taxable capital gains
Minus	The (gross) income tax and capital gains tax liability (i.e. before tax credits)
Minus	Direct and indirect foreign tax credit
Add	Non-taxed dividends received from other resident companies and Andean Community companies
Add	Tax benefits that are “transferable” to the shareholders
=	<b>The maximum amount of dividends to be distributed as untaxed dividends (MANTD).</b> I.e. these dividends do not fall under the CIT recapture tax; distributed dividends in excess of the MANTD will be taxed at the CIT recapture tax rate.

Source: DIAN

Note that if dividends have been subject to taxation at the corporate level at a reduced rate (e.g. 27%, 20%, 9% or 0% such as ZOMAC and ZESE regimes) they will not be subject to the recapture tax (i.e. they will be considered non-taxable income), as these profits were included in taxable income. However, profits that were taxed at a 0% CIT rate do fall under the CIT recapture tax, which has led to the odd situation where certain sectors such as hotels have lobbied to be taxed at a reduced CIT rate rather than having their profits classified as exempt income.

The CIT recapture tax will be levied on the difference between book (accounting) profits and the MANTD. As losses that can be carried forward reduce both accounting profits and the MANTD, the CIT recapture tax will not neutralise the carry-forward of losses. However, non-taxable, exempt income, deductions in excess of the actual cost (e.g. accelerated tax depreciation allowances), and tax credits will be offset by the CIT recapture tax. As the aim of the CIT recapture tax is to neutralise tax incentives that are given to the corporation, the question that can be raised is why these tax incentives are implemented in the first place.

Moreover, the CIT recapture tax also offsets some of the tax incentives that are justified from a tax policy perspective, such as accelerated tax depreciation allowances. Perhaps most importantly, the CIT recapture tax strongly disincentivises firms to distribute profits, which negatively affects the dynamics of the capital

<sup>24</sup> If the dividends derive from projects that qualify as Mega-Investments, the “recapture” will take place at a 27% rate. Also, if the investment made by a non-resident qualifies as a portfolio investment, the “recapture” will take place at a 25% rate.

market in Colombia, and induces companies to apply tax planning strategies so that profits can be distributed in ways that avoid the recapture tax.

### Dividend withholding tax

Individual shareholders pay a 10% dividend tax on income arising from profits from 2017 onwards with the exception of dividends derived from Mega-investments. To avoid paying the dividend tax, some taxpayers used to interpose a company between the distributing company and the individual shareholder. For this reason, since 2019, a 7.5% dividend withholding tax applies to distributions between Colombian companies. This dividend tax is charged only on the first distribution of dividends between Colombian entities, and may be credited against the tax liability of the last beneficiary (i.e. a business) of the dividend.

The interaction of the tax exemption of dividends up to 300 UVT (approximately COP 11 million or USD 2 900) and the dividend withholding tax has resulted in increased complexity and tax uncertainty. Dividends that are taxed under the 7.5% dividend withholding tax may be distributed to the final individual shareholder without any tax being levied if the dividends are below 300 UVT. It remains unclear, however, whether the distributing company will then be entitled to a refund for the 7.5% DWT that has been levied first. If not, the 300 UVT exemption does not result in a tax reduction of 30 UVT (i.e. 10% of 300 UVT) for the final individual shareholder but of only 7.5 UVT (i.e. 2.5% of 300 UVT), as an unrecoverable 7.5% dividend withholding tax has been levied upon the first distribution.

The 7.5% withholding tax does not apply in certain cases listed in Table 4.2 (these exemptions are discussed in WP3 Policy Note). In the case of taxable dividends (i.e. profits that were not subject to CIT at the corporate level), the recapture tax is withheld first and the resulting dividend will be subject to the 10% dividend tax. That dividend tax is discussed in the WP4 tax policy note.<sup>25</sup>

**Table 4.2 Dividend withholding tax rates**

	Prior to 2017	2017 and onwards
Resident - individual	0%	0 – 10 % (*)
Non-resident - individual	0	≤ 10%
Resident – entity or corporation	0%	7.5%
Non-resident - entity or corporation	0%	10% (but double tax treaties can foresee a reduced rate)
Shareholder of a company that qualified for the Mega-Investment regime	0%	0%

Notes: The first 300 Tax Value Units are exempt. The dividend withholding tax rates for non-resident individuals may be lower under certain DTT. Source: Juan Pablo Godoy (National Expert of WP2).

### Presumptive income regime (alternative minimum tax)

The tax base for CIT purposes is the higher of actual taxable income or minimum presumptive income, which is equal to 0.5% of the net equity as of 31 December of the preceding tax year. From 2021 onwards,

<sup>25</sup> The first 300 Tax Value Units (UVT) from distributed dividends to Colombian residents are exempt. This tax expenditure is discussed in the WP4 note.

the presumptive income tax rate will be set at 0%, so the alternative minimum tax will become inactive. Whether or not the regime gives rise to a negative TE is therefore no longer of practical relevancy.

### 4.2.3 SIMPLE

The SIMPLE regime is available for both businesses and the self-employed with gross revenues below 80 000 UVT (approximately COP 2.849 million or USD 771 000). These business or individuals must also fulfil the following criteria: i) be registered in the RUT; ii) invoice electronically; iii) comply with formal and substantial tax obligations of the national or territorial order; and iv) prove their compliance with obligations to the general social security system.

This regime is optional and substitutes for income tax, the municipal turnover tax (ICA) and other minor taxes (e.g. avisos y tableros, sobretasa bomberil). Occasional income (including capital gains when the gains do not constitute regular business income) and non-taxable income are deducted from gross revenues. The tax rate is flat and varies depending on the economic activity (there are four groups) and gross revenue brackets. Mandatory employer pension contributions are credited from the SIMPLE liability. The self-employed (unincorporated) entrepreneur cannot benefit from this credit. Taxpayers declare VAT and consumption tax in the same tax return, but the SIMPLE does not replace both of these taxes.

Revenues from SIMPLE are then partially allocated to municipalities as the tax replaces the municipal turnover tax. According to the Constitutional Court, this regime does not violate the autonomy of the municipalities and districts. In fact, municipalities face a tax-induced incentive to increase the ICA rate to the maximum allowed 0.7% as this would not result in an increased tax burden for the business but just results in a shift in SIMPLE revenues from the general government to the municipality.

The SIMPLE tax regime is considered to be presumptive as it aims at approximating profits (using different rates for different sectors, for example) and is levied on businesses and individuals' turnover. As a presumptive tax regime, SIMPLE could be included in the TE benchmark and therefore the regime in general would not be viewed as a TE. However, certain elements of the tax regime do constitute TEs. This is the case for the deduction of non-taxable income from the tax base, as well as the deduction of mandatory pension contributions in the form of tax credits for incorporated businesses. SIMPLE is further analysed in Section 4.4.

**Figure 4.3 From Gross Turnover to Final SIMPLE Liability**

	<b>Gross revenue</b>
Minus	Occasional income (including capital gains)
Minus	Non-taxable income
=	<b>Taxable income</b>
Tax liability	Taxable income x corresponding flat rate
Minus	Mandatory employer pension contributions
=	<b>Final tax liability</b>

#### 4.2.4 Tax revenue foregone of CIT Tax Expenditures and their impact

##### Tax revenue foregone

The Marco Fiscal de Mediano Plazo (MFMP) reports forgone CIT revenues of approximately 1% of GDP in 2019 (see Table 4.3). However, this approximation significantly underestimates the total value of CIT TEs as it does not include information on the forgone revenue associated with non-taxable income and non-standard deductions, which in the view of this Commission are considered a TE as well as reduced rates from specific regimes (see Chapter 3 for a more detailed discussion). This is both due to the absence of a clearly defined benchmark and the limited information available in tax returns. Notably, the MFMP states that “...their existence does not always imply a tax benefit for the taxpayer, given that there is not an improvement in the financial position” (MFMP, 2019, p. 492).

Revenue forgone from reduced CIT rates for companies subject to tax-favoured regimes are currently not reported in the MFMP, except for the case of FTZs, which is only included in the grand total but not in the CIT revenue forgone section.<sup>26</sup> Table 4.4 includes a partial estimate of this TE, which has been calculated by DIAN specifically for this report.

**Table 4.3 Forgone revenue from CIT expenditures in 2019**

	COP thousand million	% of GDP
<b>Published in the MFMP</b>	<b>10 104</b>	<b>0.95</b>
Exempt income	4 188	0.4
Tax credits	4 533	0.4
Tax deduction for investment in fixed assets*	803	0.1
FTZ reduced rates**	580	0.05
<b>Additional estimates not included in the MFMP</b>		
Reduced rates from selected special regimes ***	77	0.00
Deduction of 50% financial transaction tax ****	1 206	0.15

Note: Following good practice, DIAN applies the standard CIT rate as the benchmark rate when measuring revenue forgone from exempt income for companies subject to reduced CIT rates (special regimes). \* The deduction for investment in fixed assets was in place from fiscal year 2004 to fiscal year 2010 and consisted of a 30% or 40% deduction, depending on the fiscal year, from the value of the investments made in real productive fixed assets. Since 2011 the use of the deduction is allowed only for taxpayers who signed a legal stability contract where they “stabilized” the rule (section 158-3 of the Tax Code), mostly for the term of the contract. \*\* This estimate is only included in the total income tax revenue forgone in table AP1.1 of MFMP 2020 but is not reported separately. \*\*\* These regimes are described separately in table 4.4, the total reported in this table excludes revenue forgone from FTZ reduced rates as this is included in the previous line. Revenue forgone from Mega investments, theme parks, ecotourism parks, agro-tourism and nautical docks is not available since they were recently regulated or their regulation is still pending. \*\*\*\* Currently not considered as a TE by DIAN as other non-standard deductions.

Source: DIAN.

Table 4.4 shows revenue forgone for the different special regimes as well as the number of companies included in these estimates. DIAN figures show that the tax revenue foregone of the reduced CIT rate in FTZ companies amounts to about 0.05% of GDP. Nevertheless, it should be noted that these figures only

<sup>26</sup> In the 2020 MFMP revenue forgone from FTZ reduced CIT rates is only included in the total income tax revenue forgone (Table AP1.1 of the Appendix of the Annex to the 2020 MFMP) but the amount is not reported separately. Furthermore, this TE was not included in the table that lists different TEs in the Income Tax (section A.1 of the Appendix of the Annex to the MFMP).

measure revenue forgone from applying the reduced 20% rate, rather than the standard rate, to net taxable income of FTZ businesses. That is, once other TEs have already reduced taxable income. Hence, this measure cannot be interpreted as a summary of the TEs that a sector or economic activity benefits from. These low estimates show that FTZ companies use a wide range of TEs to lower their taxable income to such an extent that the actual level of the tax rate does not matter much, as their tax base is very narrow in any case. A similar conclusion can be drawn for other sectors that benefit from a wide range of TEs, such as the hotel and tourism sector.

**Table 4.4 Revenue forgone from reduced rates in 2019**

	Reduced CIT rate	Forgone revenue (COP thousand million)	Number of companies
Hotels *	9%	21	278
Book editing**	9%	24	162
FTZ ***	15 -20%	580	607
Industrial and commercial state companies ****	9%	30	19
Use of new late-yield crops*****	9%	2	36

Notes: \*Economic activities included in codes 5511 (hotels) and 5512 (aparthotels) CIU rev. 4 A.C classification. \*\*Book editing, newspapers, magazines and other publications, codes 5811 and 5813 CIU rev. 4 A.C classification. \*\*\* Article 240-1 Tax Code. No records of the application of the 15% rate for users of new FTZs in Cucuta were found (paragraph 4 of article 240-1). \*\*\*\* Industrial and commercial state companies with a state share greater than 90%, with regard to the monopoly of liquors and spirits, and gambling. Article 240 Tax Code, paragraph 2. \*\*\*\*\* Article 240 Tax Code, paragraph 1. This refers to new perennial crops (rubber, palm oil, cocoa, citrus trees and other fruit trees) cultivated before fiscal year 2014. Source: Corporate income tax returns FY 2019. SGTIT, DIAN.

The sectors that benefit the most from exempt income among CIT taxpayers are the financial and insurance activities, construction activities, and the electricity and gas supply sector (see Table A.1 in the Annex).<sup>27</sup> Table 4.5 lists exempt income by type of sector and type of income for the largest items (in total, the table presents 74% of total corporate exempt income). The main types of exempt income are exemptions in the financial and insurance companies' sector, exemptions due to the application of a Double Taxation Agreement, income from sales of social housing and land earmarked for these projects by the construction sector and income from non-profit entities. Exempt income associated to savings from mandatory pension contributions to RAIS should not be considered as a TE if Colombia chooses an exempt-exempt-tax (EET) benchmark.

The tax treaties that give rise to exempt income include Decision 578 of the Andean Community that states that income derived from certain operations between CAN countries (Bolivia, Colombia, Ecuador, and Peru) may be deemed exempt in the country of residence of the provider (source-based). However, costs incurred in Colombia to earn this type of foreign exempt income remain deductible in Colombia, which narrows the tax base. In addition, tax treaties for shipping and air transport, signed by six countries, state that profits from the operation of aircrafts in international air traffic, derived by an airline of any jurisdiction, shall be exempt from any tax on profits by the government of each jurisdiction.

However, Decision 578 may be modified to follow the OECD and UN Model Tax Conventions, if on-going discussions are resolved successfully. Notably, in 2020, Colombia and Peru drafted revisions to Decision 578, which will be presented to Bolivia and Ecuador for discussion and approval. It is therefore hoped that an update to this regime will reduce double taxation/double non-taxation and tax evasion applicable to persons domiciled in Member Countries of the CAN who carry out activities at the community level.

<sup>27</sup> Table A.1 does not include exempt income from non-profit entities.



Finally, the largest tax credits that DIAN reports are 1) the CIT credit for the Industry and Commerce Tax (ICA) (40% of total tax credits); 2) the CIT credit for VAT on investment in fixed assets (37%) and 3) the foreign tax credits for taxes paid abroad by resident taxpayers earning foreign source income (12%). Please note, however, that this report does not consider the foreign tax credit a TE, as explained above.

**Table 4.5. Exempt income by sector and type (largest items) (in COP thousand millions)**

Economic sub-sector	Concept	Concept description	Value
Financial and insurance activities	1	The income exempted by the resources of a plan financed through a personal capitalization system (RAIS in Spanish), a plan financed through a sharing system (Régimen de Prima Media in Spanish), the funds for the payment of the bonds and shares of pension bonds, of the pension solidarity fund, of the pension funds referred to in Sections 4 of Decree 841 of 1998 and 135 of Act 100 of 1993. Section. 235-2, numeral 7, T.S.	2,292
Financial and insurance activities	8168	Exempt income from loans for the acquisition of social and/or priority housing. T.S., Section 235-2, num. 6, literal e)	1,106
Supply of electricity, gas, steam and air conditioning	8120	Exempt income due to the application of a Double Taxation Agreement (DTA).	1,045
Construction	8165	Exempt income from the first sale of social interest and/or priority housing. Literal b), Num. 6, Section 235-2 of the T.S.	652
Manufacturing Industries	8120	Exempt income due to the application of a Double Taxation Agreement (DTA).	621
Financial and insurance activities	8169	Exempt income from the income generated by the stabilization reserve constituted by the pension and severance fund management entities. Act 100/1993 - Section 101 . Num. 9, art, 235-2 of the T.S.	555
Education	8142	Exempt income from net profit for non-profit entities. Section 358 of the T.S.	531
Human health care and social assistance activities	8142	Exempt income from net profit for non-profit entities. Section 358 of the T.S.	426
Financial and insurance activities	8120	Exempt income due to the application of a Double Taxation Agreement (DTA).	327
Other services activities	8142	Exempt income from net profit for non-profit entities. Section 358 of the T.S.	268
Construction	8164	Exempt income from the sale of properties intended for the development of social interest and/or priority housing projects. T.S., Section 235-2, num. 6, literal a).	249
Transport and storage	8120	Exempt income due to the application of a Double Taxation Agreement (DTA).	200
Wholesale and retail trade; motor vehicle and motorcycle repair	8120	Exempt income due to the application of a Double Taxation Agreement (DTA).	166
Accommodation and food services	8133	Exempt income for services rendered in new hotels. Num. 3, Section 207-2 of the T.S. - Decision C-235/2019.	152
Supply of electricity, gas, steam and air conditioning	8156	Exempt income for benefits from a pension fund. Section 207 of the T.S.	130
Professional, scientific and technical activities	8142	Exempt income from net profit for non-profit entities. Section 358 of the T.S.	114
Agriculture, livestock, hunting, forestry and fishing	8106	Exempt income from new forest plantations including bamboo, rubber and cashew. Section 235-2 numeral 5.	106
Construction	8167	Exempt income established by Section 16 - Act 546/1999, modified by Act 964/2005 associated with priority interest housing projects. Lit. d), Num. 6, Section 235-2 of the T.S.	77
Public administration and defense; mandatory social security plans	8142	Exempt income from net profit for non-profit entities. Section 358 of the T.S.	72
Administrative and support service activities	8120	Exempt income due to the application of a Double Taxation Agreement (DTA).	56
Professional, scientific and technical activities	8120	Exempt income due to the application of a Double Taxation Agreement (DTA).	54
Real estate activities	8164	Exempt income from the sale of properties intended for the development of social interest and/or priority housing projects. Lit. a), Num. 6, Section 235-2 of the T.S.	45
Wholesale and retail trade; motor vehicle and motorcycle repair	8142	Exempt income from net profit for non-profit entities. Section 358 of the T.S.	42

Notes: The table reports exempt income rather than forgone tax revenue. To prepare this table two sources of information were used: The breakdown by exempted income provided by the exogenous information (Form 1011) and the total value recorded by the taxpayer as Total Exempt Income in the income tax return (Form: 110). Information on exempt income by concept is missing mainly in the financial and construction sectors. The total amount of exempt income from taxpayers is COP 12 478 thousand million (approximately USD 3 thousand million). Source: Coordinación de Estudios Económicos – SGAO – DGO – DIAN.

**In the absence of TEs, the average tax burden on businesses would be extremely high**

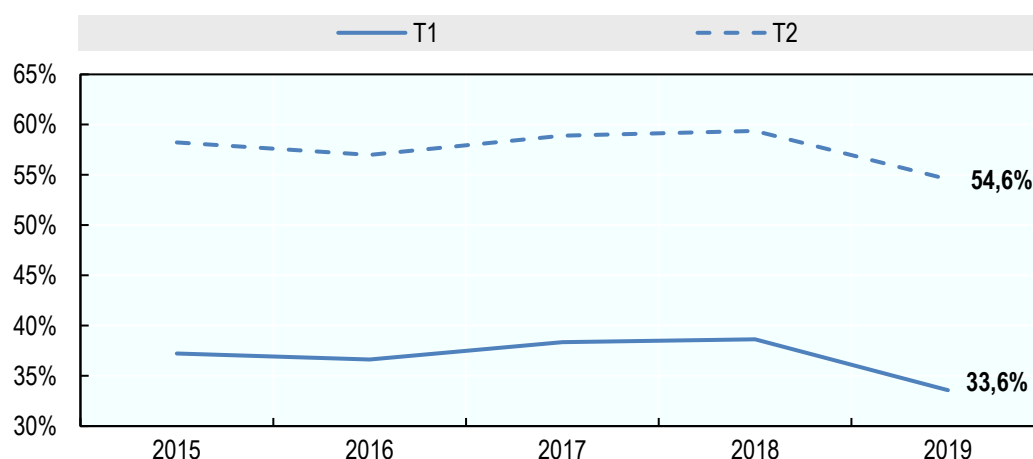
Figure 4.6 illustrates the average tax burden of business taxes as estimated by DIAN, based on a survey of large tax payers (*Grandes Contribuyentes*) in Colombia. Accounting information was provided by 2 597 companies and individuals for the financial years 2015 to 2019. The sectors with the largest representation in the survey were Wholesale and Retail Trade (24.53%), Manufacturing Industries (23.57%) and Financial and Insurance activities (8.89%).

Indicators of the average tax burden were calculated by DIAN as follows:

- T1 = Income tax, CREE and surcharges (without participation method or dividends) / Accounting profits (without participation method or dividends)
- T2 = Total taxes (Income tax, CREE and surcharges + Non-deductible VAT + Turnover tax (ICA) + Debit tax + Customs tariffs + VAT on fixed assets + Property tax + Stamps + Public lighting + Wealth tax + Stamp duty tax) / Profits before all taxes

Notably, the denominator of these indicators is defined as accounting profits minus the participation method applied to firms that pay a share of dividends to headquarters as well as dividends that are not associated to headquarters.

**Figure 4.6 In the absence of TEs, the overall tax burden on businesses would be very high**



Notes: The calculation of measures T1 and T2 are described above.

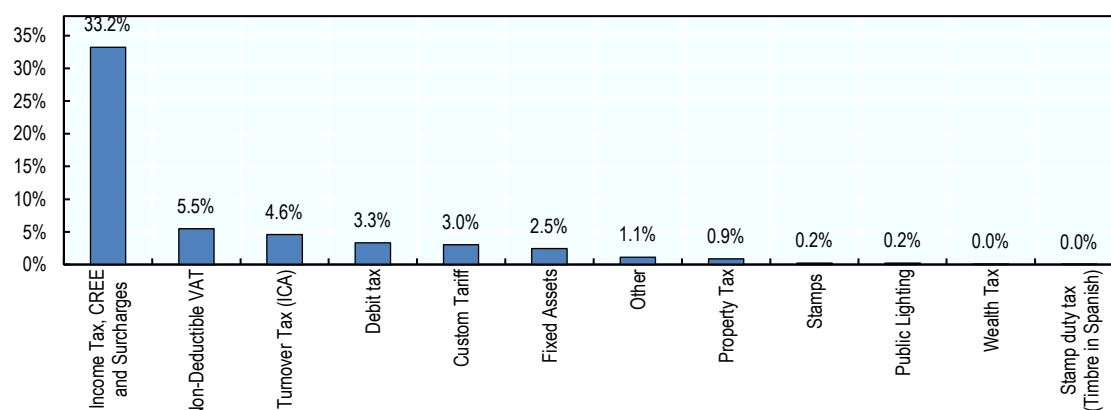
Source: DIAN.

Figure 4.6 illustrates two key points. First, on average, the tax burden faced by large tax payers (but without taking into account key TEs including tax credits) has remained persistently high. Looking at the CIT, CREE and surcharges only (indicator T1), DIAN estimates suggest that the average large tax payer would have paid approximately 33.6% of their revenue in taxes in 2019, if they were to have paid the statutory tax rates applicable for these three taxes. Furthermore, this tax burden rises by over one-and-a-half times when the additional taxes used to compute indicator T2 are included – if the average large tax payer were to have paid the statutory tax rates applicable on these taxes without the right to claim the main TEs, over 50% of their revenues earned would be paid in taxes. Second, there was a perceivable reduction in the average tax burden on large tax payers between 2018 and 2019 due to the 2019 tax reforms that included a statutory CIT rate reduction and the abolishment of the CREE.

Figure 4.7 plots the breakdown of the average tax burden by tax when indicator T2 is considered. In this case, the average tax burden in 2019 is estimated at 54.6%. Figure 4.7 shows that 33.2 percentage points are attributable to the CIT (and surcharges) while 5.5 and 4.6 percentage points are attributed to non-deductible VAT (incurred when firms sell VAT excluded goods or are denied a credit for input VAT) and the

turnover tax (ICA), respectively. The additional taxes that make up the indicator T2 then add a further 10.4 percentage points to the average tax burden, with the debit tax (3.3 p.p.), customs tariffs (3.0 p.p.) and VAT on fixed assets (2.5 p.p.) contributing the greatest share to the additional tax burden. These figures are averages; firms that invest a lot may face a higher burden of the VAT levied on investment while firms that do not sell excluded goods may face a lower non-deductible VAT burden.

**Figure 4.7 Breakdown of average tax burden (indicator T2) by tax, 2019**



Notes: Accounting information provided by 2 597 companies (FY: 2015-2019). The companies that reported information mainly belong to the Wholesale and Retail Trade subsectors (24.53%), Manufacturing Industries (23.57%) and Financial and insurance activities (8.89%)

Source: DIAN.

However, there are some concerns regarding the representativeness of the survey that should be acknowledged when reviewing these findings. The sample could be considered as small and its respondents may potentially exhibit some bias given that those wanting to respond to the survey are more likely to be those tax payers who pay the standard statutory CIT rate. In the case of indicator T1 the average tax burden rate in 2019 is estimated at 33.6%, while in the same year the general CIT rate was 33%. Surcharges would raise this tax burden, but only the financial sector is subject to a four percentage point surcharge and many sectors benefit from reduced rates (see Table 4.1). The tax burdens are therefore higher than might be expected and are somewhat misaligned with the sector-specific ETRs presented in Figure 4.8.<sup>28</sup>

Moreover, the two indicators presented above do not account for the effect of TEs on the tax burden. In particular, the CIT credits for the VAT on investment in fixed assets and the municipal business turnover tax do not seem to be taken into account in these indicators. The average tax burden is therefore likely to be somewhat smaller given the large number of TEs presented in this Chapter that would reduce large companies' tax liabilities. It should also be noted that the figures presented assume that businesses do not engage in tax avoidance and evasion strategies in order to reduce their tax burden. In reality, this does occur.

Nevertheless, these findings have a number of implications. Importantly, they illustrate just how burdensome Colombia's various business taxes can be on large tax payers despite the reduction in the tax burden in recent years. Indeed, it is because of this significant tax burden on companies and other large tax payers that TEs were introduced. In addition, the analysis shows that excluding goods and services from

<sup>28</sup> This difference would, however, be reduced marginally when using the same CIT rates – Figure 4.8 shows the 30% CIT rate that will apply from 2022 onwards, whilst Figure 4.6 uses the 2019 nominal rate of 33%.

VAT results in a significant increase in the average tax burden for businesses. This is also true of the wide range of non-profit based taxes that businesses need to pay. Some businesses and individuals may also claim that tax avoidance and evasion is done simply done to reduce their tax liability. Unfortunately, it is those who cannot afford the resources to employ these avoidance strategies that end up paying the bill for Colombia's burdensome business tax rates and narrow base.

The TIC recommends that the underlying data used in this survey, as well as business tax return data, should be studied in more depth as part of a follow-up project to identify the true effective tax rates paid.

### Sector-specific tax incentives and ETRs

Figure 4.8 reports effective CIT rates across economic sectors calculated based on tax return data. The ETR in the grey bar (abstracting from exempt income and tax credits) was estimated as follows:

$$(gross\ tax\ liability + exempt\ income * 0.3) / (net\ taxable\ income + exempt\ income + deduction\ for\ investment\ in\ fixed\ assets)$$

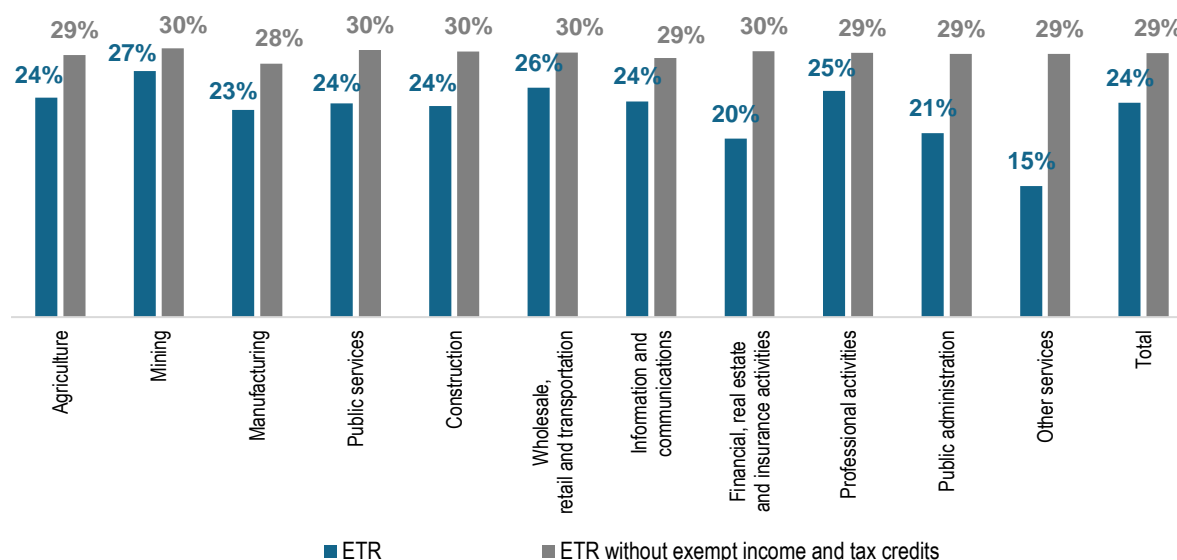
When abstracting from exempt income and tax credits, the ETRs across the different sectors approach the statutory CIT rate. The ETRs have been adjusted by the Ministry of Finance in anticipation of the 30% CIT rate that will apply as of 2022 onwards. The reason why the ETRs in the absence of TEs are not 30% could be that some firms within the broader industry sectors presented in the chart benefit from a reduced CIT rate. Note also that some sectors benefit from special tax rules; this is the case for life insurance companies, pension funds, banks, construction, air transporters and petrol stations (see Annex 4.A).

The ETR in the blue bar (in the presence of TEs) was computed as shown in the formula below:

$$(gross\ tax\ liability - tax\ credits) / (net\ taxable\ income + exempt\ income + deduction\ for\ investment\ in\ fixed\ assets)$$

It should be noted, however, that ETRs vary significantly across firm type, sector and firm size. The narrow tax base results in a wide range of tax planning opportunities. Businesses that do not actively engage in tax avoidance and, possibly, tax evasion face a competitive disadvantage compared to firms that are more aggressive in using and abusing the tax loopholes and weaknesses in the tax administration. For instance, Picon (2016) finds ETRs for the five largest Multinational Enterprises (MNEs) in the Antioquia region with headquarters in countries with which Colombia has signed a tax treaty. 4 out of 5 MNEs pay an ETR significantly below 10%, which is in contrast with the data included in Figure 4.8.

### Figure 4.8 Effective CIT rates by economic sector, 2022 forecast



Source: MOF (2020)

Notes: The scenario uses an ETR adjusted to a standard statutory tax rate of 30% expected to apply in 2022. It is based on corporate income tax returns for the taxable year 2019. This calculation only considers the payment of income tax.

### 4.3 Categorisation of CIT Tax Expenditures

The most important TE items are assigned into five categories:

- Category I: no reform is recommended/ needed
- Category II: TE base-broadening reform is desirable
- Category III: reform might be possible over time conditional upon the implementation of accompanying tax reforms
- Category IV: whether or not to reform the TE requires further analysis, but the tax revenue foregone of the TE should be measured and the TE should be assessed
- Category V: whether it is a TE depends on the benchmark

Tax incentives have been assigned in these categories following a number of criteria, including the expected value of foregone revenue, distortive impact, distributional impact and complexity. In addition, Table 4.6 below includes a fifth column that signals whether there is genuine doubt whether the non-taxable income item is actually a TE or not.

**Table 4.6 – Categorisation of CIT Tax Expenditures**

	<b>Category I: No reform</b>	<b>Category II: Reform is desirable</b>	<b>Category III: Reform is conditional</b>	<b>Category IV: Unclear whether to reform or not</b>	<b>Category V TE or not TE</b>
<b>Non-taxable income</b>	<ul style="list-style-type: none"> <li>• Non-taxable dividends</li> </ul>		<ul style="list-style-type: none"> <li>• Non-substantial sale of shares</li> </ul>		
<b>Exempt income</b>			<ul style="list-style-type: none"> <li>• Profits of Orange economy</li> <li>• Profits of the farming sector</li> <li>• Profits of</li> </ul>	<ul style="list-style-type: none"> <li>• Income of pension funds</li> </ul>	Double tax treaties are typically part of the TE benchmark

			<ul style="list-style-type: none"> <li>plantations</li> <li>Profits from the renewable energy sector</li> </ul>		and, therefore, do not give rise to TEs.
<b>Non-standard deductible costs</b>	<ul style="list-style-type: none"> <li>Accelerated tax depreciation allowances</li> </ul>	<ul style="list-style-type: none"> <li>Deduction of donations above the value of the donation</li> </ul>	<ul style="list-style-type: none"> <li>Financial transaction tax</li> </ul>	<ul style="list-style-type: none"> <li>Business immovable property tax</li> </ul>	Non-wage expenditure for workers and their families
<b>Reduced tax rates</b>		<ul style="list-style-type: none"> <li>Reduced CIT rates (in particular the 9% rate)</li> </ul>	<ul style="list-style-type: none"> <li>Reduced CIT rates (in particular 27% rate)</li> </ul>	<ul style="list-style-type: none"> <li>Surtax for financial sector</li> </ul>	
<b>Tax credits</b>	<ul style="list-style-type: none"> <li>Foreign tax credit</li> </ul>	<ul style="list-style-type: none"> <li>Credit for donations</li> </ul>	<ul style="list-style-type: none"> <li>Credit for VAT on investment in fixed assets</li> <li>Credit for municipal business turnover tax</li> </ul>	<ul style="list-style-type: none"> <li>Other CIT credits</li> </ul>	
<b>Special regimes</b>	<ul style="list-style-type: none"> <li>Non-profit organisation</li> <li>CHC regime</li> </ul>	<ul style="list-style-type: none"> <li>Non-profit organisation (in particular the 20% reduced CIT rate that applies)</li> <li>ZOMAC and ZESE (see WP3)</li> <li>Construction (profits from social housing)</li> </ul>	<ul style="list-style-type: none"> <li>Mega investments regime</li> </ul>		SIMPLE
<b>Special rules for determining taxable income</b>			Banking and insurance sector, construction, international transport, petrol stations		

Category I includes:

- [\*Non-taxable dividends\*](#): the fact that dividends that have been taxed under the CIT are not taxed again as income under the CIT would very likely be part of the TE benchmark in Colombia (if the country had defined one). This provision therefore does not constitute a TE. The TE benchmark would also include the dividend withholding tax levied at a 10% rate on behalf of the final shareholders (and withheld by the distributing company). Any exemption from this dividend withholding tax, as well as any situation where a reduced rate would apply, does constitute a TE.
- [\*Accelerated tax depreciation allowances\*](#): an analysis of whether tax depreciation allowances are aligned with the economic depreciation of the asset goes beyond the scope of this report. In general, however, accelerated tax depreciation provides a cost-based tax incentive to businesses and constitutes good practice. It provides a cash-flow advantage to firms, which can claim a larger tax deduction up front, which will be offset for the tax administration by lower tax deductions in the future. The overall tax revenue foregone for the tax

administration remains low, in particular in a setting with low interest rates, while it provides a tax incentive for businesses to invest.

- [Foreign tax credit](#): this is an integral part of a worldwide tax regime; as Colombia operates under a worldwide tax regime, this credit cannot be removed.
- [Non-profit organisation](#): the tax treatment in Colombia of surpluses of non-profit organisations that are spent on the organisation's "worthy purpose" seems aligned with the tax treatment that can be found in other OECD countries (see the OECD's "Taxation and Philanthropy" Tax Policy Study). However, this tax exemption might result in unfair competition with the for profit sector; the extent to which this occurs requires further analysis that should be carried out as a follow-up project. There are a number of control mechanisms that are in place to reduce the possibilities for tax planning – notably Articles 356-1, 358 and 364-2, but if this tax exemption is abused, there are strong arguments to reform it and to tax all commercial activity of non-profit organisations as regular business income taxed at the standard CIT rate (irrespective of how the profits are spent).
- [CHC-regime](#): overall, this regime taxes CHCs under a territorial tax regime that taxes income only if it has its source in Colombia rather than under the standard worldwide tax regime. While this constitutes a significant tax advantage compared to other businesses that operate in the financial (and other) sectors, this regime might be warranted in order for financial businesses to be competitive in an international context where many countries have lower tax rates than is the case in Colombia and operate a territorial tax system.

Members of the WP signalled that certain adjustments could be made to the CHC to avoid aggressive tax planning. This would require a more in-depth analysis of the regime, which goes beyond the scope of the report, but the Commission encourages the relevant ministries to commence the required analysis.

Category II includes:

- [Deduction of donations in excess of the value of the donation](#): The deduction of 125% of the value of the donation rather than the value of the donation is generous and the deduction might be limited.
- [Credit for donations](#): The CIT credit is equal to 25% of the total amount of donations (Section 258 of the Tax Statute). Combined with Articles 255 and 256, this CIT credit amount may not jointly exceed the 25% CIT credit available to the taxpayer in the respective fiscal year. This credit is very generous and it should be reformed, for instance by introducing a cap to the maximum amount of the credit that can be claimed. As the current CIT increases with the taxpayer's income, it is regressive in nature, benefiting those with higher incomes the most.
- [Reduced tax rate for non-profit organisations](#): the surpluses that are not invested or allocated to reach the entity's "worthy purpose" are taxed at a reduced CIT rate of 20% rather than the standard CIT rate. The rationale for this preferential tax treatment is weak.
- [The 9% reduced CIT rate](#): The very low 9% CIT rate installs an unfairness in the Colombian tax system. Providing a selection of sectors and businesses with a very low tax rate while other firms face the high 31% CIT rate undermines tax morale and creates a tax-induced incentive to avoid or evade taxes. The introduction of the 9% CIT rate has not been accompanied by a cost-benefit analysis, nor has the impact of the reduced rate ever been evaluated.
- [Profits from construction of social housing](#): the tax incentive that construction companies do benefit from when they construct social housing is a poorly targeted incentive; there are better instruments available that are more effective in ensuring that sufficient and good quality social housing units are constructed in Colombia.

Category III includes:

- [Non-substantial sale of shares](#): the capital gains realised on shares listed in the Colombian stock exchange when the sale does not exceed 10% of the outstanding shares, and when the shares are owned by the same beneficial owner, is non-taxable income. This provision is a TE, and a case can be made to align the tax treatment with other taxable business gains.

In general, many OECD countries implement participation exemption regimes under which dividends and capital gains from substantial shareholdings (e.g. more than 10% of share ownership) are exempt from tax for the business that receives the dividends and realises the capital gains. Colombia does not implement a participation exemption regime. Instead, the TE benchmark includes realised capital gains as taxable business income, except in this particular case.

Whether or not Colombia should move away from its current approach and implement a participation exemption regime is a tax policy question that is outside the scope of the report. As part of the fundamental business tax reform that this report recommends, Colombia may also want to re-evaluate the way it taxes business income earned in the form of occasional or regular capital gains. For this reason, this TE has been included in category III.

- [Profits of Orange economy](#): these tax incentives have been introduced in 2019. A competitive business tax regime would not need sector-specific tax provisions. Profit-based tax incentives should be avoided and are generally considered not to be good practice. So, while it is recognised that these tax incentives have not been properly designed and constitute a far too generous tax reduction, in particular because profit based tax incentives are a poor instrument to stimulate investment, it might be difficult to abolish these tax incentives in the short run. Instead, these tax incentives could be abolished when the general business tax regime has become more competitive (i.e. when the non-profit based business taxes have been abolished, and the standard CIT rate is further reduced).
- [Profits of farming sector and of plantations](#): profit-based tax incentives to support the agricultural sector are not cost-efficient and the challenges faced by the agricultural sector should be tackled at source rather than being addressed through the tax system.
- [Profits from the renewable energy sector](#): profit-based incentives to stimulate renewable energy production is cost-ineffective; Colombia should stimulate renewable energy through direct subsidies or through cost-based tax incentives. The current profit-based incentives can be abolished once a better system is put in place.

It should be noted that these profit-based tax incentives are, overall, weakly designed, far too generous and do not tackle the underlying problems that these sectors might face at source. The Annex contains a longer list with profit-based tax incentives that suffer from the same shortcomings. A case can therefore be made to abolish these tax incentives in the short run – in that case, these tax incentives should be included in category II. The approach taken in the report is, however, for Colombia to prepare a fundamental tax reform that broadens the CIT base, aligns the tax treatment across different sectors and lowers the tax rate for all businesses. The tax incentives in category III could then be abolished as part of such a reform.

- [Financial transaction tax](#): The “debit tax” is a distortive tax, disincentivising informal businesses from entering the formal economy and discouraging foreign and domestic investment. It should therefore be abolished, in-turn allowing the tax deduction to be removed.
- [Reduced CIT rates](#): reduced CIT rates targeted at specific sectors create distortions across sectors; the rationale for taxing a low 9% rate on certain sectors while other sectors have to pay a 31% rate is weak (the CIT rate was reduced from 32% in 2020). The aim should be to



strengthen the competitiveness of the overall business tax regime and to align the tax rate across all sectors. The category of businesses that benefit from the very low 9% CIT rate is very wide and the tax policy rationale of this tax incentive is weak. See below for a discussion of the 27% rate that applies to the mega-investments regime.

- [Credit for VAT on investment in fixed assets and the credit for the municipal business turnover tax](#): these are very uncommon CIT credits, but they have been introduced to compensate businesses for weaknesses in the design of other taxes in Colombia. These credits can be abolished only if the underlying challenges have been tackled first. This includes making input VAT on investments in fixed assets creditable against output VAT and abolishing the business turnover tax. Without such reforms, these credits should remain in place as they significantly lower the cost of capital for businesses and they correct for failures in the design of the tax system in Colombia.
- [The mega-investments regime](#): The mega-investments regime creates a distortion in favour of large investments and large businesses. Again, it is a special regime that has been introduced to compensate for the fact that the standard business tax regime is not competitive. This problem should be tackled at source rather than introducing tax-privileged regimes. While the 27% tax rate that is applied is not particularly low, the fact that investment can be immediately expensed over 2 years and that dividends are not subject to taxation are generous cost-based tax incentives. It will only be existing and profitable businesses that can fully benefit from this tax incentive, as new businesses might not make profits the first years after making a large investment.
- Special tax rules for specific sectors including banking and insurance sector, construction, international transport and petrol stations (see Annex): Certain sectors benefit from specific tax rules that determine tax liability. Whether these special rules constitute a TE (or TEs) and whether they continue to be warranted and do meet their objectives should be evaluated. Such an evaluation can be carried out as part of the preparation of a fundamental tax reform of the business tax regime in Colombia.

Category IV includes:

- [Income of pension funds](#): the reform is conditional upon the overall tax treatment of pensions. If private pension savings would be taxed under an EET approach, exempting the return on the income accumulated in the pension fund would be part of the benchmark (i.e. not considered as a TE). However, this would require the taxation of the pension received by the individual upon retirement. If Colombia would decide to tax private pension savings under a TTE approach, then the tax exemption for the return earned by private pension funds is a TE that should be reformed.
- [Double tax treaties](#): tax treaty provisions are included in the tax expenditure benchmark and are not a TE.

However, it should be noted that tax treaties could include provisions that are very similar in their impact to tax incentives. For instance, tax treaties might assign the taxing rights on certain types of income to a foreign jurisdiction (in particular if that jurisdiction is a low-tax jurisdiction), such that the home country becomes attractive as a location for foreign direct investment. These tax incentives are often less transparent than the tax incentives that are directly included in the tax code. The extent to which Colombian tax treaties include such “indirect” tax incentives is an exercise that goes beyond the scope of this report. As far as the Commission is aware, OECD countries do not attempt to estimate the tax revenue foregone of these “indirect” tax incentives and do not include these in their annual Tax Expenditure reporting.

- *Business immovable property tax*: under Article 115 of the Colombian Tax Code, immovable property tax is currently deductible from the CIT provided that such tax is associated with the economic activity of the taxpayer.

There are arguments in favour of and against the deductibility of a recurrent tax on business immovable property and OECD countries tend to differ in their approach. In general, if businesses pay through the business property tax for the local services they receive (e.g. waste disposal, fire brigade), they will not incur these costs directly but indirectly through the property tax. If direct costs would be tax deductible, one could argue that costs that are paid for “indirectly” through a fee for service paid to government should also be deductible. In this case, the business property tax could be deductible from taxable corporate profits. To the extent that the business immovable property tax exceeds a “fee for service” and is an actual tax, the payment could be made non-deductible, either fully or partly, from taxable business income.

- *Non-wage expenditure for workers and their families*: expenditure for workers such as additional health insurance, contributions for private pension savings, and other fringe benefits are deductible from taxable corporate income. Whether or not these are CIT TEs depends on how these fringe benefits are taxed under the personal income tax. If these fringe benefits are not taxed under the PIT, there is an argument to deny their deduction from taxable corporate profits. However, if these fringe benefits are valued at market value and taxed under the PIT in the hands of the employee, the costs can continue to be deducted from taxable corporate profits (see also the discussion included at the start of this chapter).
- *Surtax for financial sector*: the surtax for the financial sector is a TE with a negative value as this provision raises more revenue than the business tax regime included in the benchmark. After the 2008/9 financial crisis, many countries have introduced specific taxes for the financial sector. However, a discussion on whether or not this tax provision could be reformed goes beyond the scope of this report, as it requires an in-depth analysis of how the financial sector is taxed, including the tax base rules that apply, and that information was not shared and discussed with the Commission when drafting the report.
- *Other CIT credits*: Colombia has many generous CIT credits. Whether there is scope to make these credits less generous or abolish them (or, in fact, make them more generous) would require a cost-benefit analysis of each of these TEs.
- *SIMPLE*: Tax provisions that aim at achieving simplification and reducing compliance costs for small businesses are generally not considered tax expenditures. However, given SIMPLE’s high threshold it is hard to argue that this regime should not be listed as a tax expenditure.

## 4.4 Identifying Reform Priorities for CIT Tax Expenditures

### **Tax credits for VAT on fixed assets and municipal business turnover tax**

Colombia has been gradually lowering its standard CIT rate and abolishing some of the additional taxes levied on businesses such as the CREE and, to a large extent, the business wealth tax. However, there remain some major weaknesses in the design of the business tax system, in particular because of the additional taxes that businesses need to pay are not levied on profits. These include most notably the VAT that is levied on investment in fixed assets without which businesses have the right to credit the input VAT against the VAT they collect on their sales, the municipal business turnover tax that is levied by municipalities on business turnover and the financial transaction tax. However, Colombia has recognised that these tax design weaknesses increase the cost of capital and make the business tax system less competitive.

As from 2019 onwards, the country has therefore introduced a CIT credit that equals the amount of VAT paid on investment in fixed assets. In addition, businesses will receive a full CIT credit for the municipal business turnover tax as from 2022 onwards, and they can partly deduct the financial transaction tax from taxable income. These reforms are a step in the right direction.

These tax deductions and credits do not qualify as “tax incentives” as they do not incentivise investment but rather aim at addressing a weakness in the design of the Colombian tax system. These TEs should be maintained until the underlying challenges are fixed at source. I.e. until businesses can obtain an input credit for the VAT paid on investment in fixed assets against output VAT levied on sales, the municipal business turnover tax is abolished and replaced by a tax that is not levied on business turnover and the financial transaction tax is abolished.

The CIT credit for VAT on investment is sub-optimal as it is only partially recoverable. Indeed, the CIT credit for the VAT paid on fixed assets and the CIT credit for 50% of the municipal business turnover tax (100% as from 2022 onwards) can only be claimed by businesses that are profitable and have sufficiently high CIT liabilities. This fear is assuaged to some degree as the un-utilised tax credits can be carried forward to offset CIT liabilities in subsequent taxable years. However, if the CIT credit for the VAT and ICA cannot be claimed in the year when these tax liabilities have been incurred, they will continue to increase the cost of capital and discourage investment.

Firms may have to use the credit over different years if they have sufficient tax liability. According to DIAN, while in 2019 COP 6 000 thousand million was paid in VAT on investment, only COP 1 500 thousand million was returned through the CIT credit. Ideally, the best strategy would be for Colombia to tackle the VAT design flaws at source by having VAT on investment credited within the VAT, rather than addressing them indirectly through the CIT. In addition, the sale of fixed assets should be also subject to VAT.

In fact, these credits make the tax system in Colombia pro-cyclical. During booms when profits are high, businesses face a tax-induced incentive to invest as they will be able to benefit from the CIT credits, which will lower the cost of capital. During downturns when profits are low, and in particular if the downturns are expected to prolong over time, the opposite incentive occurs and businesses face an incentive to postpone investment until they can assure that they will have sufficient CIT liability to claim the CIT credits. Moreover, the tax credits create a tax-induced advantage for larger firms that are profitable and a bias against start-ups that do not earn large profits yet. Finally, it also creates a bias against businesses that are capital intensive.

As long as the VAT design is not changed, however, it is important that the CIT credit remains in place. The VAT reform that will provide businesses with a VAT credit for the input VAT paid on investment in fixed assets will need to be accompanied with transitional rules. Businesses that have un-utilised CIT credits for VAT paid on investment in fixed assets that took place prior to the VAT reform should maintain the right to use these credits to reduce their CIT liability. VAT paid on new investment should be credited against output VAT levied on sales.

One interesting option to explore is whether the VAT on investment can be credited gradually over time from VAT on outputs, for instance over a 3-year period, rather than in the year when the investment took place. Ideally, government would compensate businesses for the delay in refund by paying an interest rate on the deferred VAT credit. This might reduce the impact on tax revenues in the year when the VAT reform is made. Over time, Colombia could then move towards a regime that provides for the immediate refund of the VAT paid on investment, as in other OECD countries.

### **Deduction of the financial transaction tax as a business expense**

Businesses have to pay a financial transaction tax, which is levied at a rate of 0.4%; 50% of the tax paid can be deducted from taxable corporate profits as a regular business expense. However, this corporate tax

deduction only partially compensates businesses for the cost they have incurred. Indeed, for businesses that pay the standard CIT of 32%, the tax deduction yields a financial gain that equals 16% of the financial transaction tax liability (i.e. 50% of the tax liability multiplied by the statutory CIT rate of 32%); this means that those businesses incur 84% of the financial transaction tax. Businesses that face a lower effective CIT rate obtain a lower financial compensation for the transaction tax paid.

The financial transaction tax is a distortive tax and it should be abolished; this reform would then also allow abolishing the tax deduction. In fact, as long as the financial transaction tax is in place, government may consider turning it into a tax credit such that it can be fully recovered by businesses and that the deduction is not offset by the CIT recapture tax.

Another option that the government could consider is using the financial transaction tax as an instrument to strengthen the formal economy. The financial transaction tax could be turned into a tax on cash withdrawals, but no longer a tax on financial transactions through a bank or via digital means. This would increase the cost of operating in the informal economy, which is largely based on cash transactions, and incentivises businesses to enter the formal economy. This would be aligned with recent government efforts to strengthen the formal economy in Colombia, such as the introduction of SIMPLE.

### **CIT recapture tax**

As explained, Colombia levies a CIT recapture tax, which is a dividend withholding tax levied at the standard CIT rate on distributed profits that have not been taxed under the CIT (irrespective of the actual CIT rate that was levied on the profits). The design of the dividend withholding tax interacts with the value of some of the TEs within the CIT.

The CIT recapture tax does not offset the tax gain that arises from tax credits, including the CIT credit for the input VAT on investment in fixed assets. However, the tax does neutralise the impact of the TEs that take the form of non-taxable and exempt income as well as the tax incentives that allow the firm to deduct costs and expenses in excess of the actual costs, including:

- Accelerated tax depreciation allowances,
- The deduction of the financial transaction tax,
- The first-starter deduction,
- The non-taxable income that corresponds to dividends received by the business, and
- The exempt types of income that some businesses can benefit from for a number of years.

One therefore can argue that the CIT recapture tax is a safeguard that offsets a wide range of tax incentives in Colombia. Given the narrow CIT base, the CIT recapture tax ensures that businesses eventually pay the CIT rate on the dividends that are distributed. When the CIT recapture tax is levied, the wide range of tax incentives in Colombia only lead to a deferral of the CIT rather than providing an actual CIT rate reduction. However, this is not the case when firms avoid distributing dividends and engage in tax planning opportunities that circumvent the tax from being levied. While the tax protects tax revenues and corrects for the large opportunities that businesses face to limit their tax liability, it is a blunt instrument as it also offsets the impact of TEs that do have good efficiency characteristics, such as accelerated tax depreciation allowances.

Arguments exist to maintain the CIT recapture tax until the CIT base is significantly broadened and the majority of the exempt incomes are taxed as regular business income. However, once the design of the CIT has been improved, the CIT recapture tax should be abolished. However, the ongoing desire of Colombian policymakers and legislators to introduce profit-based tax incentives over the last years put such a reform that would abolish the CIT recapture tax under pressure, as abolishing the tax would imply that certain sectors would not pay much tax for many years in the future.

This then also points at the Achilles heel of the CIT recapture tax: it only is levied when profits are distributed. The tax creates a large tax-induced incentive for businesses not to distribute dividends that have not been taxed under the CIT but rather to retain them in the corporation, which will increase the value of the shares. Shareholders can then realise the profits, and avoid paying the withholding tax, when they sell the shares they hold in the corporation.

Firms might also engage in tax avoidance strategies to avoid paying the CIT recapture tax, in particular by turning dividends into capital gains/occasional income. For instance, rather than distributing dividends, businesses can use the funds to repurchase shareholders' shares and in this way the income paid to the shareholder is only subject to the 10% tax on capital gains while the distribution of dividends is deferred.

It also results in perverse effects in so far that businesses that are profitable and want to distribute dividends prefer to pay CIT at a reduced CIT rate of 9%, rather than earning tax-exempt income. Hotels, for instance, that benefit from a tax exemption for many years see their tax incentive neutralised by the CIT recapture tax when they distribute dividends. This would not occur if their profits were taxed at a reduced rate (or even zero rate), which explains why certain sectors lobby for paying a minimum amount of tax rather than being exempt.

### **Broadening the tax base should go hand in hand with lowering the standard CIT rate**

Colombia has a wide range of TEs that are generous and allow taxpayers to reduce their CIT liabilities significantly and underutilises more common forms of corporate taxation. Colombia is thus forced to employ taxes that are not seen elsewhere in OECD countries because of their distortive nature. The municipal business turnover tax, financial transaction tax and VAT burden on investments in fixed assets are but a few examples of how the Colombian tax system itself distorts the functioning of the economy.

A large number of these CIT incentives cannot be seen in isolation from the current design of the business tax system, with its high rates and the additional taxes that have to be paid by businesses. There is a wide consensus that a CIT base broadening reform should go hand in hand with a reform that abolishes some of these additional taxes and further reduces the standard CIT rate.

### **The SIMPLE regime should be simplified**

Presumptive tax regimes<sup>29</sup> may be used for different reasons. A presumptive tax presumes a different tax base than income in the calculation of the firm's tax liability. Usually, the main reason for implementing such a regime is simplification, particularly in relation to the compliance burden on small businesses (and the corresponding administrative costs of managing the tax and auditing taxpayers). Tax compliance costs involve recording transactions, maintaining financial and tax accounts, calculating tax liabilities, making various tax payments to the government, etc. Since compliance costs have a significant fixed component, they impose a relatively higher burden on smaller firms as a percentage of turnover or profit, or per employee. Calculations according to a presumptive tax scheme may also provide taxpayers with greater certainty regarding their tax liabilities. Another important reason is to limit tax avoidance or evasion. If well administered, these regimes are likely to have a strong signalling effect encouraging informal entrepreneurs to become compliant. This is accomplished only if the proxy of income on which the presumption is based is more difficult to hide than those forming the basis for accounting records (Thuronyi, 1996<sup>[15]</sup>). A presumptive tax can also be designed to ensure that a minimum level of tax is collected from small businesses. Finally, presumptive tax regimes can incentive small firms to enter the formal economy.

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<sup>29</sup> As described in Section 4.2.3, the SIMPLE tax regime is considered to be presumptive as it aims at approximating profits (using different rates for different sectors, for example) but is levied on businesses turnover.

Presumptive regimes should never be thought of a replacement of the standard regime even if the standard regime critically needs to be simplified, as is the case in Colombia. A presumptive tax regime should be targeted at small businesses only; larger businesses should file a tax return under the standard tax regime. For instance, liberal professions typically do not need a special regime that reduces compliance costs. This report has pointed out several times that the standard tax regime in Colombia is overly complex and needs a fundamental reform that broadens the base, lowers the rates and simplifies the tax system. However, the weaknesses of the design of the standard tax regime should not be resolved by widening the scope of SIMPLE beyond the main objectives of a presumptive tax regime, as currently is the case.

The threshold of a presumptive tax regime is an important feature in itself. International experience shows that high thresholds can lead companies to create new smaller companies that can benefit from the reduced tax rates of presumptive regimes, leading to inefficiencies and inequities in the tax system. SIMPLE's current turnover threshold is situated around 771 000 USD, which is high by international comparison, and indicates that the regime partly compensates for weaknesses in the design and administration of the standard business tax regime. An independent analysis of the value the SIMPLE ceiling should be set at, which includes the budgetary implications of any decision, would help provide guidance for reforming the turnover threshold in the medium term.

Avoiding sharp tax burden increases in the transition from the presumptive to the regular tax regime is critical. Presumptive taxes increase the risks of horizontal inequity if they generate a disproportionate burden on small firms or, on the contrary, if the tax burden is excessively low compared to the regular business tax. Highly profitable firms with turnover below the eligibility threshold may prefer the presumptive tax regime to the regular regime while less profitable firms may prefer the regular regime instead. Having different presumptive tax rates for sectors that have very different profitability ratios (so that the tax rate better approximates the profitability of the sector) can help address the discontinuity between the presumptive and the regular regime. However, this creates additional complexity. Alternatively, tax rates can increase with turnover such that businesses with a high turnover would be subject to higher presumptive tax rates and the move from the presumptive to regular taxation would not generate a significant increase in businesses' tax liabilities. Nonetheless, this also introduces complexity. SIMPLE's current design combines both and this approach may bring advantages. However, DIAN needs to evaluate to which extent businesses that have turnover below the maximum threshold do actually face a tax-induced incentive to enter the regular tax system, as optimal tax design would require. If this is not the case, the rate schedule that is applied will need to be adjusted. Such an evaluation should go hand in hand with an evaluation of the level of the turnover threshold.

SIMPLE is less simple than it looks at first sight and so government may want to consider strategies that simplify SIMPLE. In Colombia, non-taxable income is not included in the SIMPLE base and SIMPLE taxpayers must assess occasional gains under the general regime.

The SIMPLE regime is most favourable for labour intensive sectors as the value of the mandatory pension contributions credit increases with the amount of salaries paid. This likely has a positive impact on employment and incentivises employers to formalise their employees in order to benefit from the tax credit. On the other hand, however, the SIMPLE regime also incentivises the self-employed to incorporate. This is because the owners of an unincorporated business are not able to deduct their own pension contributions from their tax liability.

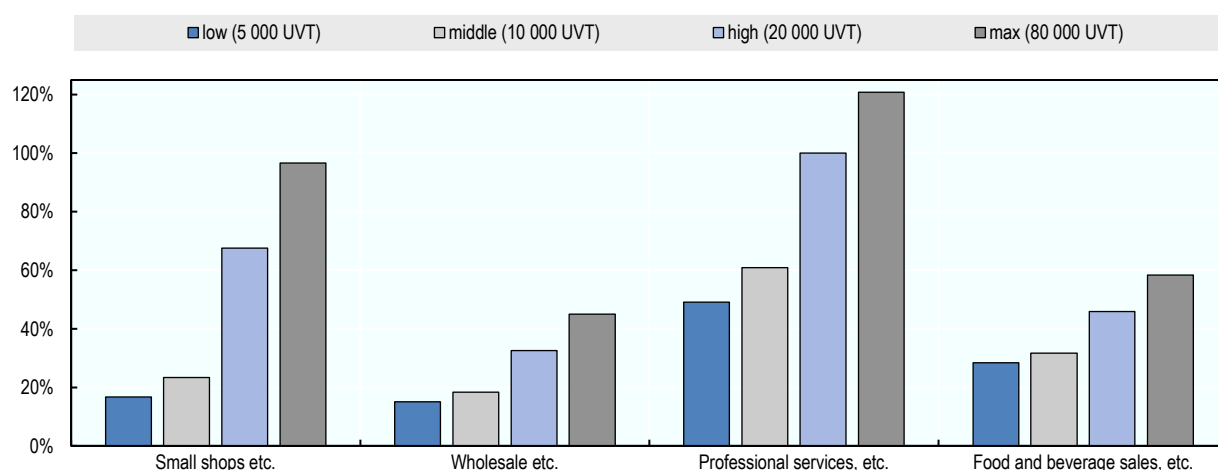
Moreover, a number of businesses with low turnover levels may end up not paying any taxes, as the amount of salary necessary to incur high enough pension contributions for their tax liability to be zero is fairly low. Figure 4.9 shows that a small retail store with a turnover of 10 000 UVT (approximately 356 million COP or USD 96 000), for example, would only need to pay 18% of that amount (1 834 UVT) in wages to reduce its SIMPLE liability to zero. Similarly, a hairdresser with a closely held corporation with the same turnover would only need to pay 23% of their turnover (2 333 UVT) in wages in order to avoid paying the SIMPLE tax. On the other hand, because business activities in the professional service or food and beverage

sales categories are subject to higher tax rates, a closely held corporation offering, for example, legal services with a turnover of 10 000 UVT would need to pay 61% of their turnover (6 083 UVT) in wages to reduce their SIMPLE tax liability to zero.

To ensure that the mandatory pension contribution tax credit does not allow profitable small businesses to significantly reduce (or eliminate) their SIMPLE tax liability, the tax credit could be capped at a given share of the tax liability. Such a policy would ensure that businesses in the SIMPLE regime do not avoid the tax through larger salaries. Another option would be to reduce the value of the credit by allowing only a portion of the mandatory pension contributions to be credited and/or increase the SIMPLE tax rates.

However, such solutions would only be sub-optimal. The main aim of the SIMPLE is to bring informal businesses and their workers into the formal economy. SIMPLE does not aim to raise a lot of revenue, so having a credit for pension contributions that incentivises entrepreneurs to register their workers and the salary that they pay is an important objective that can be incentivised through a generous tax credit, if and only if, the SIMPLE is targeted at small informal businesses. This argument provides further support to significantly lower the SIMPLE turnover threshold.

**Figure 4.9 The share of wage costs (in % of turnover) where tax liability is zero (by company size and activity)**



Source: OECD calculations based on information provided by DIAN

An excessively low tax burden compared to the regular tax regime can discourage firm growth or create incentives for firms to artificially remain below the presumptive tax eligibility threshold, underreporting turnover or artificially splitting their activities into separate businesses. To prevent businesses from underreporting their turnover, DIAN could require businesses to report, along with their turnover, other indicators (e.g. salaries, energy costs, number of rooms in the case of accommodation services), which could then be relatively easily matched with turnover data to detect potential inconsistencies.

The presumptive tax should remain optional if the objective is to minimise compliance costs. If the presumptive tax is primarily used as a minimum tax, then it could be made compulsory below the threshold. However, such an approach might be questionable, as the minimum tax would only apply to businesses below the turnover threshold and might possibly impose a higher tax burden on businesses with a lower turnover. If the main objective of this regime is to reduce compliance costs and to incentivise businesses to enter the formal economy, the presumptive tax should remain optional. Nonetheless, once businesses choose a regime, it should apply for a certain number of years to avoid yearly shifts between the presumptive and the regular regime.

Businesses that file a SIMPLE tax return and have turnover above the VAT threshold may not be able to recover the input VAT paid on investment in fixed assets as they cannot enjoy the CIT credit in relation to the VAT paid on investment (as they are liable for SIMPLE instead of the CIT). Rather than introducing another credit within SIMPLE, the government should restore the functioning of the VAT and provide a timely refund for input VAT that can be credited against VAT levied on sales.

Finally, the Tax Incentives Commission holds the view that it would be unwise to introduce an additional special tax regime that would sit in between SIMPLE and the standard tax regime. The current tax system is already very complex and introducing yet another special regime would be a step in the wrong direction.

## 4.5 Conclusions and Reform Options

Colombia needs a fundamental business tax reform that broadens the tax base, simplifies the tax system, aligns tax treatment across different sectors, abolishes the distortive non-profit based taxes (including the equity tax), and abolishes the financial transaction tax. This ambitious reform should go hand-in-hand with a significant reduction in the statutory CIT rate. Fundamental tax reform is the only viable option if Colombia wants to break out of the vicious complexity-breeds-complexity cycle that it is currently trapped in. A reform of this proportion is not only a question of tax reform, but will also require a fundamental change in the mind-set of Congress and legislators who need to stop over using the tax system to tackle problems that lie beyond its scope.

### Reforming the overly complex and distortive CIT regime

The CIT in Colombia is complex because of the:

- Special tax rules that have been introduced to offset the effects of the various non-profit based taxes that businesses have to pay, which appear to change with each reform;
- Tax incentives introduced to mitigate the distortive impact of the standard tax regime;
- Complex procedure in determining the CIT taxable; and
- The preferential tax treatment that is provided to some sectors or types of investment.

Over recent years, the CIT rate has decreased and some additional business taxes have been abolished (the CREE, the alternative minimum tax and, to a large extent, the business wealth tax). Moreover, the impact of distortive non-profit based taxes has been somewhat offset via tax deductions or tax credits within the CIT. These reforms are welcomed, but the tax burden remains high and the business tax system continues to be distortive and inequitable.

In particular, Colombia levies VAT on investment but the input VAT cannot be credited against the VAT levied on sales. Consequently, this turns the VAT into a cost on investment and raises the cost of capital. Municipalities levy a business turnover tax and central government levies a financial transaction tax. In 2019, new tax credits have been introduced that lower the CIT liability for the VAT on investment in fixed assets and the business turnover tax. The financial transaction tax liability is a deductible business expense. These TEs solve the distortion partly, but not entirely, and they do not tackle the problems at source, which remains a reform priority; these TEs should remain in place until the underlying tax distortions have been resolved.

While Colombia has been introducing tax reforms that have reduced the tax burden, it also has been very active in introducing special tax regimes in an attempt to stimulate investment and economic development. These tax incentives have increased complexity, distortions and inequity between different sectors, enforcement costs and tax planning opportunities. Instead of introducing additional tax incentives, Colombia should fundamentally simplify its business tax regime and lower its standard CIT rate significantly. The suggestion to introduce a limit to the overall TEs that businesses can claim would be sub-



optimal as it does not tackle the problems at source. A first best reform would be to broaden and simplify the tax system such that there are no longer too many overly generous TEs available.

### **Improved TE reporting**

Efforts to measure and report tax incentives and TEs need to continue, including a sector-specific analysis of the types of TEs that are used and the effective tax rates that are paid within and across the different sectors in the economy, and the different special tax regimes that have been created. The revenue foregone of the CIT TEs need to be estimated on an item-by-item basis and discussed within an annual TE report. This will increase transparency and accountability of policymakers when they consider introducing future tax incentives.

### **The CIT recapture tax**

The CIT recapture tax (i.e. the dividend withholding tax levied on untaxed corporate profits) is a rather uncommon approach to protect the tax base. In order to prevent firms from distributing dividends that have not been taxed at the CIT rate – facilitated by the wide range of tax incentives that are in place – the government has introduced the CIT recapture tax. This tax offsets a wide range of tax incentives that are in place, in particular with respect to non-taxable income, exempt income and deductions that exceed actual costs (such as accelerated tax depreciation allowances), as well as tax credits. While the tax protects tax revenues and corrects for the large opportunities businesses face to limit their tax liability, it is a blunt instrument as it also offsets the impact of tax expenditures and tax incentives that have good efficiency characteristics, such as accelerated tax depreciation allowances and the CIT credits for the VAT on investment and the municipal business turnover tax. The CIT recapture tax is therefore highly distortive in itself.

Arguments exist to maintain the CIT recapture tax until the CIT base is significantly broadened and the majority of the exempt incomes are taxed as regular business income. However, once the design of the CIT has been improved, the CIT recapture tax should be abolished. The CIT recapture tax has further increased the complexity of the tax system and has led to unintended side effects and distortions, such as a tax-induced incentive for businesses not to distribute dividends, which needs to be evaluated in a context where capital gains are taxed more favourably than dividends at the individual level. The rationale for the CIT recapture tax has become weaker since Colombia has started taxing dividends at the personal shareholder level. A significant CIT base broadening reform that would only maintain a limited number of well-designed tax incentives could therefore go hand in hand with abolishing the CIT recapture tax.

### **SIMPLE**

Colombia has introduced SIMPLE, which is a presumptive tax that replaces the standard tax regime for small (and not so small) businesses. The stated objective of SIMPLE is to incentivise businesses to enter the formal economy and to ensure that their workers have access to health and pension entitlements; this approach is very much welcomed. However, as improvements are made to Colombia's wider corporate tax regime, policymakers may wish to review whether the design of SIMPLE is sufficiently targeted at small firms, and in particular whether the turnover ceiling is set at the correct level. An independent analysis of the value the SIMPLE ceiling should be set at, which includes the budgetary implications of any decision, would help provide guidance for reforming the turnover threshold in the medium term.

Businesses that file a SIMPLE tax return rather than a CIT return are not able to benefit from the CIT credit for the VAT on investment in fixed assets. Rather than introducing a new credit for VAT on investment that can reduce the SIMPLE liability, the government should strengthen the design of the VAT so that input VAT can be credited against output VAT, including for investment.

Currently, SIMPLE is an optional regime, which is a good design, but businesses should be taxed under the regime for a minimum number of years, once they have chosen for the regime in order to prevent tax planning. The scope of SIMPLE should be broad so that it covers all small businesses across all sectors, and it should be better promoted to those sectors in which it has a low take-up, including the agricultural sector. This would allow the regime to play a role in inducing businesses to enter the formal economy and to register workers within the social security system.

### **Abolish the local business turnover tax ICA**

The local business turnover tax (ICA) is a particularly distortive tax that should be abolished. Because it is levied on turnover instead of profits, it forces businesses with a high turnover but low profit margin to face a very high effective tax rate levied on their profits. However, removing the tax would create funding issues for local administrations who rely heavily on its revenue streams. Therefore, until local governments are funded through less distortive taxes, such as recurrent taxes on immovable property, and/or larger grants from central government, the tax credit within the CIT for the local turnover tax ICA should be maintained, despite the fact that it reduces the revenue raising potential of the CIT. Only profitable businesses can benefit from the tax credit, so the distortion of the ICA is not entirely corrected for with the CIT credit. Notably, the 100% tax credit can encourage territorial entities to increase the ICA rate to maximise their revenue compensation, again highlighting the distortive nature of the business turnover tax, and reinforcing the need to abolish the ICA as soon as possible.

Instead of compensating large businesses for their ICA liability through a CIT credit, government could increase the grant it provides to local governments, which would compensate local governments for the loss in tax revenues when they abolish the ICA. For small firms, the government already pays part of the revenues it raises from SIMPLE to local governments to compensate for the fact that SIMPLE replaces ICA for businesses with turnover below 80 000 UVT. The government therefore has all the necessary tools available to abolish the ICA and improve the business climate. But, as pointed out, this will require a change in the way central government funds local governments.

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# Annex 1.B. All Tax Expenditures Pertaining to the CIT

## Non-taxable income

A number of important non-taxable income items are listed below:

- Business profits from the sale of shares registered in the Colombian stock exchange, owned by the same beneficial owner, are non-taxable income when the sale does not exceed 10% of the outstanding shares;
- Dividends received by partners, shareholders and the like when the profits being distributed were already taxed by the company distributing the dividends (if the conditions of article 48 of the Colombian tax code are met);
- Dividends and benefits distributed by a CFC, as well as the remnants distributed at the time of liquidation of the CFC, when such profits were taxed in accordance with CFC rules;
- Income provided from the sale of shares or participations in a CFC that correspond to profits that were subject to taxation in accordance with CFC rules;
- Profits from new hydrocarbons and mining investments that link to the certificates of investment given by the Ministry of Finance;
- Profits distributed by mutual funds, investment funds and stock funds to their investors are deemed as non-taxable in the part that corresponds to the inflationary component of financial returns received by the fund and when the payment is made by a well-defined list of entities. Inflation-related component of interests received by others than individuals are deemed as non-taxable in a percentage of 90% of such inflationary component.
- Distributions of profits as shares or partnership interest, as a result of the capitalisation of (i) the equity revaluation account or (ii) reserves of non-taxable or exempt profits in the case of corporations registered on the Colombian stock market.

## Exempt income

A number of important exempt income items are listed below:

- Foreign entities which are entitled to apply the tax exemptions set forth in international treaties;
- A 7-year tax exemption for income earned by companies engaged in the technological and creative sectors (Orange economy). This tax incentive has been introduced in 2019; it applies to companies exclusively engaged in the development of 1 of the 27 business activities defined as the “creative industry”, including jewellery manufacturing; book publishing; film, music, radio and television production; software development; architecture and engineering and other activities related to technical consultancy; theatre and other cultural activities; cultural tourism activities;
- A 10-year exemption for income derived from investments made that increase the productivity in the farming sector;

- A 15-year exemption for income derived from the sale of electrical energy, carried out by generating companies, derived from wind energy, biomass or agricultural, solar, geothermal or marine waste;
- Any gains from the sale of property earmarked for public interest projects or social interest projects (social interest housing projects);
- Income derived from new forestry plantations, including guadua, rubber and cashew, as well as income from plantations of timber trees and fruit trees;
- A 15-years exemption for income obtained from the provision of fluvial transport services with boats and low draft slabs;
- Income of authors and translators of national or foreign authors of books, published and printed in Colombia;
- Income obtained by pension funds;
- Exempt income derived from the application of Decision 578 of the Andean Community of Nations.

The following tax incentives were repealed in 2016:

- A 30-year exemption for income perceived by new hotels or refurbished hotels that were built within the following 15 years as of the entry into force of the law in 2002. This tax incentive was repealed in 2016;
- A 20-year exemption for income derived from the provision of agro-tourism services. This tax incentive was repealed in 2016;

### **Deductible costs and expenses**

In general, costs incurred to earn taxable business income are deductible; this includes regular financing expenses, necessary expenses and expenses incurred abroad, salaries and payroll taxes, taxes, interests and depreciation, and losses. In addition, there are a number of deductible costs/ expenses that are less common and that very likely would not be included in the tax benchmark (if Colombia would define one). These deductions would then be classified as TEs, and the corresponding tax revenue foregone should be included in the Colombian annual TE report. The following items could possibly be considered as TEs:

- 50% of the financial transaction tax (GMF) can be claimed as a cost;
- First job deduction: 120% deduction of the total salary payments made to first-job employees under 28 years old;
- Scholarship allowances granted to employees: payments made by the employer to fund full or partial scholarship programs for the benefit of their employees or the employees' families;
- Tax depreciation allowances that are not aligned with the economic depreciation of the asset; taxpayers may deduct reasonable amounts of depreciation for the normal wear and tear or the obsolescence of fixed assets used in any income-producing business activities. Annual depreciation rates range between 2.2% and 33%;
- 100% of the recurrent tax on business immovable property is deductible (if the tax has a direct relationship with the production of income);
- Donations to the National Network of Public Libraries and the National Public Library; donations to cinematographic projects produced or co-produced by Colombian persons.

### **Reduced tax rates**

As pointed out, certain types of sectors and investments benefit from a reduced CIT rate or have to pay a surtax on their profits, which gives rise to, respectively, positive and negative TEs. Free Trade Zones are not discussed in this note but in the tax policy note of WP5.

- 9% reduced rate for industrial and commercial state companies, publishing companies, new hotels and/ or renovated hotels, theme parks, ecotourism parks, agro-tourism and nautical docks;
- 27% reduced rate for mega-investments or 9% in the case of hotels;
- Surtax for the financial sector

### **Tax credits**

A number of tax credits can be claimed:

- Foreign tax credit for taxes paid abroad by resident taxpayers earning foreign source income;
- 25% of the investments made in control, conservation and improvement of the environment, provided that the investment is certified by the environmental authority;
- 25% of investments made in research, technological development or innovation certified by the National Council for Tax Benefits in Science, Technology and Innovation. Alternatively, 50% of the remuneration paid to personnel hired with a doctorate degree (both tax credits cannot be claimed jointly);
- 25% of donations made through institutions of higher education or the Colombian Institute of Educational Credit and Technical Studies Abroad (ICETEX), addressed to programs of scholarships or forgivable credits, that are approved by the Ministry of Education (as of 2019);
- 25% of donations paid to the National Fund for the Financing of Science, Technology and Innovation;
- 25% of donations granted to non-profit entities qualified under the CIT special regime and to CIT non-taxpayers as stated in articles 22 and 23 of the Colombian tax code;
- A 2-year tax credit of 50% of investment made in research, technological development or innovation certified by the National Council for Tax Benefits in Science, Technology and Innovation made by micro, small and medium-sized businesses;
- A 2-year tax credit of 50% of the remuneration payments made by micro, small and medium-sized businesses to personnel hired with a doctorate degree;
- VAT on the import, formation, construction or acquisition of real productive fixed assets can be claimed as an income tax credit in the tax year in which they pay the VAT or in any subsequent tax years;
- Taxpayers are entitled to claim 50% of the local turnover tax that they pay as a CIT credit. As of 2022, the tax credit will be 100%.
- As from tax year 2020, foreign audio-visual works fully or partially produced or post-produced in Colombia are entitled to a Certificate that entitles the holder to an income tax credit equal to 35% of the amount invested in Colombia;
- Donations to specific entities or programmes: companies can sign agreements with the Colombian Sports Institute to sponsor scholarships for athletes to study and pay for their living expenses. These donations give rise to a tax credit.

The tax credits for investments in monitoring, conserving and improving the environment and for investments in qualified research and technology development projects cannot exceed 30% of the annual CIT liability; the excess can be carried forward for four years. The sum of these two tax credits and the tax

credit for donations to specific entities or programmes cannot exceed 30% of the annual income tax liability.

Moreover, the tax credits cannot exceed income tax liability. Moreover, the net tax liability (so net of tax credits) cannot be lower than 75% of the presumptive income tax liability before any tax credit.

### Tax treatment of specific sectors or group of taxpayers

- **Petrol stations.** For tax purposes, retail fuel suppliers determine their gross income multiplying the selling profit margin per the number of gallons sold, deducting the margin of loss due to evaporation. From the gross income, the taxpayer cannot subtract costs deriving from the acquisition of liquid fuels and petroleum derivatives. The abovementioned does not include costs related to the transportation of liquid fuels and petroleum derivatives, nor other deductible expenses linked with the operation.
- **Insurance companies.** Life insurance companies (LIC) as well as general insurance companies (GIC) must apply a special formula in order to determine their gross income, as follows:

Operation	Concept
	Total net income earned during the fiscal year (FY)
Add	Mathematical reserve at the end of the previous FY (in the case of LIC) / technical reserve at the end of the FY (in the case of GIC)
Minus	a) Payments or accruals of insurance claims, expired endowment insurance policies and life annuities (for LIC) / Payments or accruals of insurance claims (for GIC) b) The amount of the notified claims, until the concurrence of the non-reinsured part c) Special benefits paid on expired policies (for LIC) d) Salvages paid (both LIC and GIC) and salvage expenses or claims adjustments (for GIC) e) Amount of reinsurance premiums assigned in Colombia or abroad f) Amount of mathematical reserve at the end of the FY (for LIC) / Amount of technical reserve at the end of the FY (for GIC)

### Concession agreements and public-private associations

Costs and expenses must follow the intangible asset model stated in article 32 of the CTC:

- The amortization of intangible assets are calculated using the straight-line method and taking into account the term of the agreement;
- The recognition of revenues for tax purposes must follow special rules depending on the stage of the contract;

- With respect to the recognition of revenues associated with the construction stage, the taxpayer must accumulate such revenues as a deferred tax liability;
- This deferred tax liability is recognized as a revenue for tax purposes using the straight-line method and taking into account the term of the agreement.

## Banking

Financial institutions can deduct the individual provision for doubtful or difficult debts in accordance with a specific provision. Particularly, the following items are deductible for those institutions:

- Credit portfolio provision and risk coefficient provision realized during the respective fiscal year (FY).
- Provisions realized during the respective FY related to goods received in *lieu* of payments and leasing agreements.

The following expenses linked with portfolio provisions will not be deductible:

- Those that exceed those required by law and prudential regulation regarding financial entities.
- Those that are voluntary.

## Reporting standards

- Banking establishments, financial corporations, financing companies, financial cooperatives, higher-level cooperative organizations and insurance entities must apply a special accounting-reporting framework for the preparation of their financial information.

## Construction

For construction contracts, the recognition of income, costs and deductible expenses takes into account the Percentage of Completion Method, as follows:

- A budget must be drawn up with the total income, costs and deductions of the contract, at the beginning of its execution;
- In each fiscal year (FY) the proportional part of the income, costs and deductions must be attributed;
- The difference between the part of the income thus calculated and the costs and deductions, constitutes the taxable income of the corresponding FY;
- At the end of the execution of the contract, the necessary adjustments must be made;
- When it is probable that the total costs of the contract will exceed the total revenues derived from it, the expected losses accounted will not be deductible for CIT purposes, only until the end of the contract, to the extent that has been made effective.

## International transport

Income derived from air, sea, land and river transportation obtained by foreign companies or non-resident individuals who regularly provide transportation services between Colombian and foreign places is considered as a mixed income.



The part from the mixed income which is deemed as Colombian source income and subject to CIT, is the amount which keep with the total net revenue obtained by the taxpayer (within and outside Colombia regarding the transport business), the same proportion between their gross revenue obtained in Colombia and their total revenue derived from their transport services worldwide.

**Table A.1 Exempt income and revenue forgone by sector of activity, 2019, COP thousand million**

Economic sub-sector	Exempt income amount	Revenue forgone
Public administration and defence, compulsory social security	23	8
Education	11	3
Agriculture, forestry and fishing	186	61
Transportation and storage	267	88
Real estate activities	123	40
Accommodation and food service activities	300	99
Construction	1,528	504
Other service activities	29	10
Arts, entertainment and recreation	6	2
Financial and insurance activities	4,915	1,692
Electricity, gas, steam and air conditioning supply	1,189	392
Human health and social work activities	20	6
Professional, scientific and technical activities	141	46
Administrative and support service activities	64	21
Information and communication	65	21
Manufacturing	668	221
Water supply; sewerage, waste management and remediation activities	85	28
Wholesale and retail trade; repair of motor vehicles and motorcycles	212	70
Mining and quarrying	21	7

Source: DIAN

Note: This table only includes exempt income from taxpayers. However, total exempt income amounted in 2019 to 12 478 COP thousand million, this includes also non-profit entities which are not subject to CIT.



# Working Party 3: Non-taxable and exempt income and gains as well as tax benefits for the countryside

Tax Expenditures Report



## 5. Working Party 3: Non-taxable and exempt income and gains as well as tax benefits for the countryside

*There are significant tax base broadening opportunities with respect to the “non-taxable” and “exempt” income items, as well as capital gains, in both the CIT and PIT. While some TEs call for immediate action, other TEs can better be addressed as part of a fundamental reform of the capital income tax system, both at the corporate and personal shareholder level. Key examples of TEs that can be immediately reformed include the preferential tax treatment of the remuneration of selected officials, the non-taxation of pensions (up to a high threshold), and the dividend withholding tax exemption for mega investments. In addition, the value of the voluntary health, pension, housing and education payments made by employers for their workers should be included in personal taxable income and taxed under the PIT. Tackling these TEs would constitute a significant tax base broadening effort.*

*The division of items into the categories “non-taxable” and “exempt” income and capital gains is unique in the OECD and reflects the complexity of Colombia’s tax system, and with the abolishment of the presumptive income tax, this distinction can be abolished too. The new category of exempt income items should be narrow in scope in two ways. First, items that are not income should not be included. Second, as many income items as possible should be taxed, either immediately or gradually over time, under general CIT and PIT rules.*

*Colombia implements a wide range of tax incentives for the agricultural sector. The resulting tax revenue foregone of these incentives is small because the sector is largely informal and operates outside of the tax system, but such incentives are inefficient as they do not reach the businesses and farmers that need support the most. The formalisation of the agricultural sector should be the main priority for government. This will require a well-developed formalisation strategy that includes tax and non-tax measures that tackle the problems of the agricultural sector at source, including through investment in infrastructure. The TIC welcomes that SIMPLE is available to all small businesses, including farmers. SIMPLE serves a dual objective: incentivising farmers to enter the formal economy, and, as they will be paying SSCs when they are part of the formal economy, they will be entitled to benefit payments. The tax-deductible workforce cost equivalent to 40% of taxable income for coffee growers needs to be abolished. One important non-tax measure that should accompany tax reforms is to incentivise farmers to register their property. Government should facilitate registration by reducing the tax and non-tax costs of registration. Other measures could be included in the action plan to formalise the agricultural sector. The rural zones in Colombia face many economic challenges, and the government has recently attempted to stimulate economic growth through the introduction of profit-based tax incentives such as ZOMAC and ZESE. However, these programmes do not tackle the problems at source. Instead, Colombia should continue to implement its regional development plans that contain infrastructure improvements, removing all profit-based incentives and using cost-based tax incentives where necessary.*

### 5.1 Introduction

Colombia has a wide range of income that it considers “non-taxable” and that therefore does not have to be included in the tax base of the personal or corporate income tax. Different authors have been using a

wide variety of criteria to determine whether a particular type of income should be taxable or non-taxable, including whether the income increases the “net equity of the taxpayer” or whether the income implies a “structural reduction” of the tax burden. These approaches are complex, remain unavoidably vague and somewhat arbitrary. Instead, Colombia should define a TE benchmark, which would allow for the identification of TEs in a relatively straightforward manner, as explained at the start of this report.

In addition to “non-taxable income”, Colombia has a separate category of “exempt income”. The distinction was relevant in the past for presumptive income tax purposes, but that tax has now been de facto abolished through a 0% rate. From a TE analysis perspective, the distinction between “non-taxable” or “exempt” income is irrelevant; what matters is whether a certain type of income is considered “income” under the TE benchmark. In addition to the “non-taxable income” items, this chapter will therefore include the tax provisions that constitute “exempt income”; which is considered for the purposes of the analysis in this chapter as “income that does not have to be added to the taxpayer’s gross income and that is taxed under the PIT or CIT”.

However, it should be noted that in contrast to “non-taxable income”, which is fully excluded from taxable income, the amount of “exempt income” and “deductions” (i.e. tax allowances) is restricted by the tax code such that the amount cannot exceed 40% of total income and/or 5 040 Tax Value Units (“Unidad de Valor Tributario”, UVT). This restriction only applies to individuals with an employment contract. Certain types of exempt income, however, do not fall under that ceiling, such as education and healthcare payments paid to employees by their employers. Companies do not face a limit on the amount of exempt income, and other individuals such as the self-employed or individuals who only earn capital income face a 10% limit on the amount of exempt income and deductions that they can benefit from.

## 5.2 Tax Expenditures on non-taxable and exempt income and capital gains

The list of non-taxable income is large. It includes a wide range of incomes that are overall low in value. These low value items will not be referred to in this section but are listed in the Annex. In addition, certain items correspond to government subsidies, such as for urban mass transport, the development of scientific, technological or innovative projects, and the promotion of regional television. While these subsidies could be taxed as income in the hands of the recipient, this would not result in a cost saving for government as it might require higher subsidies to provide the same net-of-tax subsidy to the beneficiaries. These items are not discussed in the TE analysis.

This chapter will categorise the most important<sup>30</sup> “non-taxable” income items into four categories: “non-taxable general income”, “social contributions”, “non-taxable capital income” and “non-taxable capital gains”. The chapter will also list the most important exempt income and exempt gains items.

The categories and category items that have been included in the analysis were identified by the Members of Working Party 3 at the start of the work of the Tax Incentives Commission as possible TEs. While other classifications could have been made, and certain items might not be seen as “income” in other OECD countries and therefore do not give rise to a TE, this chapter reflects the terminology used in the Colombian tax code and literature.

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<sup>30</sup> A more complete list of the tax incentives and expenditures pertaining to individuals, employment, pensions and dividends is available in the annex of this chapter. Importance is judged against a number of criteria, including the value of foregone revenue, distortive and distributional impacts, and complexity.

### Non-taxable general income

- [Damage insurance](#): the value of compensation in money or in-kind provided from insurance of damages;
- [Assets from divorce](#): assets received as a consequence of divorce are deemed as non-taxable income. However, allowances (i.e. alimony payments) received after divorce are taxed;
- [Student support](#): economic support for students given by the State;

### Social contributions

- [Pension SSCs](#): Mandatory contributions made by employees, independent professionals, employers and members of the General System of Social Security of Pensions and voluntary contributions if these contributions are made to the pension funds that also manage the mandatory pension contributions are not be part of the basis to calculate the income tax withholding and are considered to be non-taxable income;
- [Health SSCs](#): Mandatory contributions made by employees, independent professionals, employers and members of the General Health Social Security System are not part of the basis to calculate the income tax withholding and are considered to be non-taxable income.

Note that pension and health contributions made by employees and independent professionals are tax deductions that might qualify as being TEs, depending on the TE benchmark that is applied. This is discussed in more detail in the WP4 chapter. The compulsory contributions made by employers are a deductible business cost for CIT purposes. Compulsory employer social contributions are not included in taxable personal income in Colombia, as is the case in the majority of OECD countries<sup>31</sup>.

### Non-taxable capital income

- [LLC liquidation profits](#): Profits distributed as a result of the liquidation of a limited liability company up to the amount of the capital contribution made by the shareholder;
- [Previously taxed dividends](#): Dividends received by partners, shareholders and the like when the profits being distributed were already taxed by the company distributing the dividends. For this purpose, they must meet the conditions set forth in article 48 of the Colombian Tax Code;
- [Dividends derived from Mega-Investments](#):<sup>32</sup> Dividends from mega-investments are not taxed under the dividend withholding tax (i.e. 7.5% when dividends are distributed to another corporation or 10% when distributed to an individual shareholder);
- [Profits used to repurchase shares](#): Rather than distributing profits as dividends, corporations can decide to repurchase own shares. The decision to acquire its own shares must be made by an assembly with no less than 70% of the votes of the shares subscribed and the acquisition must be made with cash-available profits. There are no special tax rules for these operations, and the CIT recapture tax is not levied first on profits that are used to repurchase shares;
- [CFC dividends and benefits](#): Dividends and benefits distributed by a CFC, as well as the remnants distributed at the time of liquidation of the CFC, when such profits were taxed in accordance with CFC rules;
- [Investments for mining and hydrocarbon exploration \(CERTs\)](#): As an incentive to increase investment in exploration of hydrocarbon and mining, the national government has granted

<sup>31</sup> Except in the Czech Republic where personal income and employer SSCs are added to form a gross value that is taxed under the PIT.

<sup>32</sup> Income tax taxpayers that make new investments in Colombia over 30 000 000 of Tax Value Units (COP 1 068 210 000 000 = USD 289 174 337) and comply with other requirement set by the law, can qualify for the Mega-Investment regime.

Tax Refund Certificates (CERTs) to taxpayers who have made additional investment in these activities. The Certificate has a value that corresponds to a set percentage of the investment and it can be used for the payment of taxes over a fixed number of years. Additionally, CERTs can be traded on the stock market. The issued CERTs have been treated as non-taxable income.

- [\*Profit from property sales \(1978-1986\)\*](#): Profit provided from the sale of immovable property acquired since 1978 to 1986, where the percentage of non-taxable income decreases from 1978 (100% non-taxable) to 1986 (10% non-taxable);
- [\*Inflation on capitalised income and interest\*](#): Inflationary component when capitalised and on interest paid by financial entities and investment funds.

### Non-taxable capital gains

- [\*Sale of CSE listed company shares\*](#): Income from the sale of shares of a company listed in the Colombian Stock Exchange (CSE) when such sale does not represent more than 10% of the total number of shares of the listed company;
- [\*Capital gains out of untaxed profits\*](#): The disposal of fixed assets that have been held for more than 2 years are only taxed at a capital gains tax rate of 10%, irrespective of whether the underlying profits that give rise to the capital gain have been taxed under the CIT or not. The CIT recapture tax does therefore not apply to capital gains;
- [\*Sale of shares of a CFC\*](#): Income from the sale of shares or participations in a CFC that correspond to profits that were subject to taxation in accordance with CFC rules.

### Exempt income

Colombia also exempts a wide range of income items from CIT or PIT. The most important “exempt income” items are listed below:

- [\*Compensation for work-related accidents or illness\*](#);
- [\*Maternity leave payments\*](#);
- Severance payments and interest earned on severance payments, provided they are received by employees whose average monthly salary in the previous 6 months does not exceed 350 UVT;
- [\*Pensions\*](#): Retirement, disability, old age, survivors and professional risks pensions up to 1 000 UVT per month (i.e. UVT 12 000 per year) are considered exempt income. Pensions received from foreign pension funds do not fall under this tax exemption and they are fully taxable;
- [\*Military and police salaries\*](#): Amounts received in excess of the basic salary by officers, sub-officers and professional soldiers of the military forces, and officers, sub-officers, executive level, patrol officers and agents of the national police;
- [\*Judge and prosecutor salaries\*](#): As from tax year 2020, 50 percent of the salary earned by judges of second-tier courts and public prosecutors, and 25 percent of the salary earned by judges of first-tier courts;
- [\*Representation fees of Deans/Professors\*](#): Representation expenses received by deans and professors of public universities, up to 50 percent of their salary;
- [\*Voluntary pension contributions\*](#): Voluntary contributions paid by the employer or self-employed individuals (or employees) to private pension insurance and pension funds, administered by entities subject to the surveillance of the Financial Supervisory. Note that the contributions paid by the employee are deductible from taxable personal income, and are therefore not included here but in the PIT policy note;

- ***Voluntary construction savings contributions:*** Voluntary contributions paid by the employer or self-employed individuals (or employees) deposited in special savings accounts to promote construction, limited yearly to the lesser of 3 800 UVT or 30% of total income in the year. The exemption does not apply if the funds are used for other purposes than purchasing family housing, or if the resources are withdrawn within a 10-year term if contributed or deposited from 1 January 2013 onwards.
- ***Employer education and health payments:*** Education and health payments made by the employer for the benefit of the employee are not part of employment income, as long as they do not exceed the average amount allowed to the majority of employees for education and health purposes and they correspond to permanent programmes of the company for its employees.
- ***Employee food payments:*** Payments made by the employer to employees or their families for food up to a monthly amount of 41 UVT are exempt income of the employee. This tax treatment only applies to employees with employment income below 310 UVT per month. Some additional conditions need to be met when the payment is made through vouchers.
- ***Private use of a company car:*** Transport reimbursements are exempt from individual income tax if the employee provides the employer with invoices to support the reimbursement. This includes the private use of the company car made available by the employer, tickets for fuel costs and maintenance, and the payment of the insurance premium in respect of a vehicle used by the employee for work purposes.
- ***Reforestation initiatives:*** The government subsidizes 50% of the costs of reforestation of protective-producing plants. This income is non-taxable.

### Exempt capital gains

Colombia also exempts a wide range of capital gains from tax. This can partly be explained by the fact that the country levies tax on inheritances and donations under the capital gains tax rather than under a special tax as in most other OECD countries. The most important “exempt capital gains” items are listed below:

- **Inheritances:**
  - ***Urban dwelling owned by the deceased:*** 7 700 UVT of the value of the deceased’s urban dwelling is not taxed under the capital gains tax;
  - ***Rural property owned by the deceased:*** 7 700 UVT of the value of the deceased’s rural property
  - ***Inheritance received by the heirs:*** 3 490 UVT of the amounts received as marital share or as an inheritance or legacy by the surviving spouse and each of the heirs;
  - ***Inheritance received by non-relatives:*** 20% of the inheritances or legacies received by individuals other than relatives and the surviving spouse, up to 2 290 UVT;
- ***Donations:*** 20% of the donations or other free-of-charge inter-vivos gifts up to 2 290 UVT;
- ***Gains from immovable property:*** Profit derived from the sale of homes, up to 7 500 UVT;
- ***Life insurance proceeds:*** Life insurance proceeds up to 12 500 UVT;
- ***Under-valuation of immovable property gains:*** Owners who sell their property can choose between different valuation methods of the capital gains, including the self-assessment method that allows to reduce taxable gains by claiming high costs that have been incurred to maintain and improve the property;
- ***Under-valuation of capital gains from inheritances:*** valuation is based upon historical cost of the asset rather than the market value of the asset;

- Under-valuation of donations: When a physical person receives a property or asset as a donation, the value that has to be declared is the historical cost of the property or asset and not the market value of the property or asset that has been donated.

### Tax revenue foregone

This section presents tax revenue foregone of some of the main non-taxable income items as well as the exempt-income for businesses and individuals.

**Table 5.1 Tax revenue foregone by non-taxable income, non-exhaustive list of large items, COP thousand million**

Description	2018			2019		
	Number of Taxpayers	Fiscal cost	% Total Tax Revenue	Number of Taxpayers	Fiscal cost	% Total Tax Revenue
Resources for scientific, technological or innovative projects	36	527	0.28%	45	595	0.38%
Public funding for urban mass transport network	25	322	0.17%	26	357	0.23%
Compensation from insurance of damages	779	95	0.05%	951	274	0.17%
Distribution of shares provided from the capitalization of revaluation's account (from companies listed on the Colombian Stock Exchange)	31	7	0.00%	39	224	0.14%
Profits from the sale of shares of companies registered on the Colombian Stock Exchange (<10% of total shares)	377	138	0.07%	481	134	0.09%
Investments for mining and hydrocarbon exploration (CERT)*				7	121	0.01%
Income received by regional television organizations the National Television Commission	7	56	0.03%	7	26	0.02%

Notes: \*Figures refer to data from 2020

Source: DIAN

Table 5.2 reports exempt income from both corporate and personal income. In the case of individuals, their tax returns only include one cell where all tax allowances and exempt income are reported together for each income type (labour income, capital income, etc.). Thereby, revenue forgone from exempt income cannot be estimated separately from revenue forgone from tax allowances and no disaggregation on an item-by-item basis is possible.

**Table 5.2. Estimated forgone revenue from exempt income in 2019,**

	COP thousand million	% of GDP
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Exempt income (corporate income)	4 188	0.4
Exempt income and tax allowances (personal income)	6 554	0.6

Note: To estimate PIT revenue forgone DIAN applies an average marginal rate based on the information available from the tax returns at the time of publication of the MFMP. Applying the average marginal rate is not only imprecise because it is an average (rather than applying the PIT schedule to the individual tax return) but it underestimates forgone revenue from TEs as in the case of labour, pensions, capital and non-labour income where different rates for different brackets apply, all the exempt income and special deductions are assumed not to make taxpayers change the PIT bracket when tax expenditures are added to taxable income.

Source: MFMP (Anexo al Apéndice 1).

## 5.3 Categorisation of Non-Taxable Income Tax Expenditures

The most important non-taxable income items are assigned into four TE reform categories:

- Category I: no reform is recommended/ needed
- Category II: TE base-broadening reform is desirable
- Category III: reform might be possible over time conditional upon the implementation of accompanying tax reforms
- Category IV: whether or not to reform the TE requires further analysis, but the tax revenue foregone of the TE should be measured and the TE should be assessed

In addition, Table 5.3 below includes a fifth column that signals whether there is genuine doubt whether the non-taxable income item is actually a TE or not.

The paragraphs below the table provide a more in-depth discussion of a number of the items included in the table. The existing tentative categorisation takes into account the following dimensions:

- The tax revenue foregone;
- The distributional implications, in particular if the TE has a significant regressive distributional impact;
- The impact on the complexity of the tax system, the extent to which the TE creates tax planning and avoidance opportunities, and the extent to which the TE creates challenges with respect to its administration, compliance and enforcement.

**Table 5.3 Categorisation of non-taxable and exempt income and gains**

	<b>Category I: No reform</b>	<b>Category II: Reform is desirable</b>	<b>Category III: Reform is conditional</b>	<b>Category IV: Unclear whether to reform or not</b>	<b>Items that do not give rise to TEs</b>
Non-taxable and exempt income and gains	<ul style="list-style-type: none"> <li>• Damage insurance</li> <li>• Assets from divorce</li> <li>• Student support</li> <li>• Pension SSCs</li> <li>• Health SSCs</li> <li>• LLC liquidation profits</li> </ul>	<ul style="list-style-type: none"> <li>• Dividends from Mega-investments</li> <li>• Compensation for work-related accidents</li> <li>• Maternity leave</li> <li>• Severance payments</li> <li>• Pensions</li> <li>• Military and police salaries</li> </ul>	<ul style="list-style-type: none"> <li>• Sale of shares listed on the Colombian Stock Exchange</li> <li>• Capital gains out of untaxed profits</li> </ul>	<ul style="list-style-type: none"> <li>• Inflation on capitalised income and interest</li> <li>• Investments for mining and hydrocarbon exploration</li> <li>• Inheritances</li> <li>• Donations</li> </ul>	<ul style="list-style-type: none"> <li>• Damage insurance</li> <li>• Assets from divorce</li> <li>• Student support</li> <li>• Pension SSCs</li> <li>• Health SSCs</li> </ul>

	<ul style="list-style-type: none"> <li>• Profit from property sales (1978-1986)</li> <li>• Reforestation initiatives</li> <li>• Previously taxed dividends</li> </ul>	<ul style="list-style-type: none"> <li>• Judge and prosecutor salaries</li> <li>• Representation fees of Deans/Professors</li> <li>• Voluntary pension contributions</li> <li>• Voluntary construction savings contributions</li> <li>• Employer education and health payments</li> <li>• Employee food payments</li> <li>• Private use of a company car</li> <li>• Undervaluation of immovable property gains</li> <li>• Undervaluation of inheritances</li> <li>• Undervaluation of donations</li> <li>• Life insurance proceeds</li> </ul>	<ul style="list-style-type: none"> <li>• Profits used to repurchase shares</li> </ul>	<ul style="list-style-type: none"> <li>• Gains from immovable property</li> <li>• CFC dividends and benefits</li> <li>• Sale of shares of a CFC</li> </ul>	<ul style="list-style-type: none"> <li>• LLC liquidation profits</li> <li>• Previously taxed dividends</li> <li>• CFC dividends and benefits</li> <li>• Sale of shares of CFC</li> <li>• Investments for mining and hydrocarbon exploration</li> <li>• Inflation on capitalised income and interest</li> </ul>
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Source: OECD analysis based on information provided by WP3 of the Tax Incentives Commission.

### Category I includes:

- **Damage insurance:** this compensation is linked to an insurance to compensate in case of an economic loss. The proceeds of this type of insurance are generally not considered as income. The non-taxation does not give rise to a TE because the insurance simply compensates for the loss.
- **Assets from divorce** refer to a transfer of (financial or non-financial) assets. They can therefore be treated as non-taxable. In fact, this transfer is not income, but concerns the transfer of an asset. This item therefore does not give rise to a TE in the income tax.
- However, the alimony that is received is taxed as income for the receiver, which implies that the payment should be treated as a tax-deductible cost for the payer.
- **Student support:** most students do not file a tax return so taxing financial support paid to students would be impractical and would be a transfer of funds from the government to itself. It is not obvious that this item is a TE.
- **Mandatory pension and health SSCs:** in most countries, mandatory employee “social” contributions (for health, pensions, etc.) are deductible from taxable personal income. In fact, many countries would include these contributions in their TE benchmark and would not consider them as a TE. OECD countries, for example, tend to follow an “Exempt-Exempt-Taxed” (EET) treatment for mandatory employee social contributions. In this approach, social contributions are deductible from taxable income, the return earned within the (public or private) fund where the contributions accumulate over time are not taxed, but the replacement income that is received is considered taxable income. If the TE benchmark were

to follow such an EET approach for mandatory social contributions, tax treatments that differ from EET would give rise to (positive or negative) TEs. In addition, compulsory pension and health social security payments made by the employer are a deductible business cost for the employer but are not included in the employee's taxable income. This is the case in all OECD countries (except the Czech Republic), as pointed out before.

- **LLC liquidation profits:** Profits distributed because of the liquidation of a limited liability company up to the amount of the capital contribution made by the shareholder does not constitute income as the payment reflects a return of funds that has been paid by the shareholder to the company at an earlier stage. The “non-taxation” is not a TE.
- **Profit from property sales (1978-1986):** this provision is a right that has been given in the past, so it might not be opportune to reverse that decision.
- **Previously taxed dividends:** Distributed dividends that were already subject to CIT at the firm level are non-taxable income. There are strong arguments to consider this tax treatment as part of the benchmark, and this tax treatment does not give rise to a TE.

#### Category II includes:

- **Dividends from Mega-Investments:** Dividends from Mega-Investments are not taxed under the 7.5% or 10% dividend withholding tax that applies to dividends distributed by other companies and out of other investment projects. This tax treatment differs from the standard tax treatment. It is clearly a TE that needs reform.
- **Employee food payments:** The remuneration (in cash or through vouchers) paid by the employer to employees or their families for food up to a monthly amount of 41 UVTs is exempt income of the employee. However, there is an overlap with the VAT exclusion for basic food expenditure and the VAT compensation that poor households receive from the government. The rollout of the VAT compensation mechanism reduces the justification for this TE.
- **Voluntary payments made by the employer on health, education, housing and pensions** that the employees will benefit from are fringe benefits and should be included in personal taxable income, and valued at their market value. While mandatory employer SSCs are not included in taxable personal income across OECD countries, the opposite holds for voluntary payments made by the employer. As these fringe benefits are deductible as a cost from taxable corporate profits, they should be taxed as part of personal income.
- **Favourable tax treatment of certain professions:** Some professions have received favourable tax treatment that violates notions of horizontal equity that all incomes should be taxed alike.
- **Pensions:** Given the deductibility of mandatory and voluntary pension contributions and the fact that pension funds are not taxed on the return on investment they earn, the non-taxation of pensions up to UVT 1,000 is a large TE that calls for reform. See also the chapter of WP4.
- **Undervaluation of immovable property gains, inheritances and donations:** these TEs call for reform as assets need to be valued based on the actual market value. However, Colombia does not have a standardized cadaster with information of properties and their market value. Local governments are responsible for updating the Fiscal Cadastre, but this has not been a policy priority for them. A number of Colombia's largest cities have been able to improve their revenues by updating land values to reflect the market price, and this good practice should be implemented throughout the entire country. The Government is developing a multipurpose cadaster, but this project is in pilot survey stage and will not be operational before 2025. In the meantime, taxpayers are required as from fiscal year 2021 onwards to self-declare the market value of their property. To discourage taxpayers from undervaluing their property and induce them to declare the market value, the government should act on

the right to purchase assets at the declared value and purchase undervalued properties. The government should then ensure that these cases are communicated widely so that the threat becomes credible, inducing taxpayers to self-declare the market value of their property.

- **Life insurance proceeds:** Life insurance proceeds up to 12 500 UVT are not taxed. First, the life insurance proceeds can be divided into an amount that corresponds to the original life insurance contributions that were made augmented by a return on investment that has accumulated within the insurance fund. Insofar as the original contributions were not tax-deductible, the part of the life insurance proceeds that corresponds to the original savings should not be taxed; the non-taxation is therefore not a TE. In case the original contributions were taxed, this would then give rise to a negative TE. However, insofar as the return on investment has not been taxed at the level of the insurance fund, the part of the life insurance proceeds that corresponds to the return on the savings should be taxed, and if not, there is a TE. The current tax treatment of life insurances that provides an exemption up to 12 500 UVT and levies a 10% tax rate on the amount above the threshold is not aligned with this approach. As part of a broader capital income tax reform, the taxation of life insurance proceeds can be reviewed and reformed. It should be noted that death proceeds of life insurance policies are not taxable in several countries. Alternatively, this reform could be advanced and included in a PIT reform that would significantly broaden the PIT base.

#### Category III includes:

- **Sale of shares of a company listed on the Colombian Stock Exchange:** Realised capital gains from unlisted shares that do not represent more than 10% of the total number of shares are taxed under the capital gains tax, so the fact that shares receive a preferential treatment should be considered a TE. This TE has been in place for several years and has proved ineffective in terms of promoting the development of the financial sector. While this TE can be reformed in the short run, there are good arguments to include it in category III and to reform the TE as part of a fundamental reform of the capital income tax system in Colombia, which would lower the capital tax burden at the corporate level and partly shift it to the personal shareholder level. Working Party members of DIAN and the Ministry of Finance signalled that the impact of this TE should be analysed in more depth before the tax rules would be reformed.
- **Capital gains out of untaxed profits:** The CIT recapture tax does not apply to capital gains for assets that have been held for more than 2 years. Under the assumption that the CIT recapture tax is part of the benchmark, the fact that the tax does not apply to realised capital gains but only to dividends is a TE;
- **Profits used to repurchase own shares:** Rather than distributing dividends, firms can use their profits to repurchase own shares. While profits that are distributed will be taxed under the CIT recapture tax if they have not previously been taxed under the CIT (irrespective of the rate), this does not apply to profits that are used to repurchase shares. There is no good justification for this differential tax treatment, so this could be reformed. The reform of this TE is “conditional” as this report recommends a fundamental review of the capital income tax system at both the corporate and personal shareholder level.

#### Category IV includes:

- **Investments for mining and hydrocarbon exploration (CERTs):** CERTs can be used for the payment of taxes over a fixed number of years. They are clearly TEs, but whether or not they have been designed optimally goes beyond this report.
- **Inflation on capitalised income and interest:** the inflationary component in the return on capital income is not actual (net) income, but rather compensation for the loss in purchasing

power because of inflation. In this sense, the return is not income. Whether or not this provision could be reformed depends on the extent to which this non-taxable inflationary component is provided to all types of capital income or only to a selected number of financial instruments, and whether or not Colombia wants to tax nominal or real returns. If the latter, it should apply the same rules for all types of capital income in order to prevent a distortion in savings behaviour as is currently the case. In summary, as only interest can benefit from real rather than nominal taxation, this tax provision is a TE that should either be reformed or extended to all types of savings. This topic will need to be addressed when Colombia defines its TE benchmark.

- **CFCs: dividends and benefits as well as sale of shares:** A TE arises if the taxes on dividends received from CFCs and the proceeds of the sale of shares of CFCs differ from the standard tax treatment that applies to dividends and capital gains from other firms. It should be noted that the treatment of dividends and capital gains with respect to CFCs is not viewed as a TE as it is intended to eliminate double taxation. Whether or not there is scope to reform the CFC rules in Colombia goes beyond the scope of this report.
- **Inheritances, donations and gains from immovable property:** the corresponding tax exemptions are clearly TEs but the extent to which they are too high (or low) is a matter of tax policy design and depends on an evaluation in terms of efficiency and equity. Following practice in many other OECD countries, Colombia could introduce an inheritance tax and a gift tax.

## 5.4 Tax Expenditures for the countryside

The Colombian countryside accounts for 24% of the Colombian population and generates 15.6% of national employment, largely through the agricultural sector. Poverty is significantly more widespread in these rural areas than among the urban population; at 39.3% of the population, the incidence of multidimensional poverty in the countryside is 26.1 percentage points (pp) higher than in urban areas. The countryside is also characterised by widespread informality, both in land ownership (59% of property is informally held) and labour relations (90% of employment is informal), while less than 11% of agricultural units submit applications for credit and financial services. These factors substantially limit who is eligible for the tax benefits in rural areas and thus the scope of take-up.

There are a host of tax incentives designed for the Colombian countryside that have largely been employed to address the sector's low productivity and hence profitability, which may otherwise deter investment and reduce the incomes and quality of life of the rural population. Foremost amongst these are VAT exclusions on agricultural inputs that seek to dampen the impact of elevated production costs, while incentives also include lower income tax rates for certain crops and agricultural tourism.

Special economic zones also feature within the tax incentives provided in the Colombian countryside. In 2017, the Colombian government introduced tax relief for companies investing in Zones Most Affected by the Armed Conflict (Zonas más Afectadas por el Conflicto Armado (ZOMAC)), providing progressive reductions on the income tax rates of companies who invest in these zones over a period of 10 years with the objective of stimulating investment and local growth. Special Economic and Social Zones (Zonas Económicas y Sociales Especiales (ZESE)) were introduced in 2019, providing companies with similar preferential income tax rates for ten years to incentivise investment in some of the departments that share a national border with Venezuela and metropolises with relatively high unemployment rates.

### The agricultural sector

There is a wide range of tax expenditures targeted at the agricultural sector. This section will focus and categorise the most important items, which can be grouped into the following four categories:

## Preferential tax rates

- [\*Perennial crops \(pre-2014\)\*](#): A preferential income tax rate of 9% for new perennial crops cultivated before fiscal year 2014. The tax incentive applies for ten years after the start of the crops' production and applies to rubber, palm oil, cocoa, citrus trees and other fruit trees;
- [\*Agricultural tourism\*](#): A preferential income tax rate of 9% for the agricultural tourism sector;
- [\*Productivity enhancing investments\*](#): Income derived from investments that increase the productivity of the agricultural sector are exempt from income tax for the following ten years (under the condition that the investments comply with a certain set of requirements);
- [\*VAT Exclusions\*](#): Agricultural goods and services are VAT excluded, although some of them are taxed at a reduced 5% rate. No VAT is charged on the majority of farm inputs and agriculture outputs (both domestically produced and imported). These TEs have been discussed in the VAT Tax Policy Note.

## Other tax incentives

- [\*Coffee growers' labour costs\*](#): Rather than deducting the actual labour costs, coffee growers have a deemed tax-deductible workforce cost equivalent to 40% of taxable income;
- [\*Investments in listed agricultural firms\*](#): Taxpayers who invest in agricultural companies listed on the stock market have the right to deduct the value of the investment as a tax credit, which may not exceed 1% of their taxable income.

## Subsidies outside of the tax system

- [\*Incentives for rural capitalisation\*](#). The incentive consists of a payment made to the balance of the credit with which the investment project was financed.
- [\*Forestation subsidy\*](#) (Certificado de incentivo forestal). As previously described, the government subsidizes 50% of the costs of reforestation of protective-producing plants.

## ZOMAC and ZESE

### ZOMAC

New companies established in one of the Zones Most Affected by Conflict (ZOMAC) benefit from tax rate relief for a period of 10 years; in these zones, the following rates apply:

- Micro and small companies benefit from a 0% rate for the period 2017-2021; 25% of the standard rate for the period 2022-2024 and 50% of the standard rate for the period 2025-2027.
- Medium and large companies will have preferential tax rates of 50% of the standard rate for the period 2017-2021 and 75% of the standard rate for the period 2022-2027.

### ZESE

Preferential tax regime for Economic and Social Special Zones (ZESE); 0% income tax rate for the first 5 years and 50% reduction in the standard tax rate for the following 5 years. The preferential tax treatment applies to the following departments: La Guajira, Norte de Santander and Arauca, and the Capital Cities of Armenia and Quibdó, which are the departments with the highest unemployment rates in the country. All commercial corporations that are created within three years following the entry into force of the law (May 25, 2019) are eligible as well as all commercial corporations that were already active in the departments before the law, but companies must demonstrate that they have increased (and maintain) their labour force by 15%. The main business activity must be the development of industrial, agricultural, commercial, tourism or health activities; all economic activity must be carried out within the ZESE.

### Tax revenue foregone

Table 5.4 presents the information on tax credits and exempt income targeted at the agricultural sector. The agricultural activities that benefitted the most from exempt income in 2019 were new forest plantations including bamboo, rubber and cashew (COP 106 thousand million).<sup>33</sup> The information provided by the DIAN suggests the costs are small, which is explained by the fact that the sector is largely informal and operates outside the tax system. Tax incentives targeted at the agricultural sector therefore largely miss their objective, as they do not reach the businesses and farmers that need the support the most.

**Table 5.4 – Exempt income and tax credits to Agriculture, livestock, hunting, forestry and fishing subsector, COP thousand million**

	2018	2019
Tax Credits	8	46
Exempt income	157	226

Note: The table reports exempt income not revenue forgone associated to this income.

Source: DIAN

Revenue forgone from ZOMAC reduced rates is estimated at COP 66 thousand million in 2019 (see Table 5.5). Note this estimate does not represent a summary of all the TEs companies under this regime use to reduce their tax liability. This estimate considers revenue forgone from applying the reduced rate rather than the standard rate to net taxable income. That is, once other TEs (e.g. exempt income, non-standard deductions and non-taxable income) have already reduced taxable income. Revenue forgone estimates from ZESE are not available yet as this regime was only regulated in 2019.

**Table 5.5 Revenue forgone from ZOMAC reduced rate, COP thousand million**

	2018	2019
Companies that calculate Income Tax at a 0% rate	26	65
Companies that calculate Income Tax at 50% of the general rate	0.4	0.9
Total	27	66

Notes: Companies with location in the municipalities indicated in Decree 1650 of 2017 and whose corporate name in the income tax returns contains the word ZOMAC and that the tax is settled at 0% or 50% of the general tax rate.

Source: Corporate Income tax returns, Fiscal Years 2018 and 2019 and RUT, cut-off date October 30, 2020. Análisis de Operaciones, SGTIT, DIAN. Prepared by Coordinación de Estudios Económicos. SGAO, DIAN.

## 5.5 Categorisation of Tax Expenditures for the Countryside

Table 5.6 categorises the TEs for the countryside in five areas based on whether tax reform is desirable or not.

**Table 5.6 – Categorisation of non-taxable and exempt incomes**

	Category I: No reform	Category II: Reform is desirable	Category III: Reform is conditional	Category IV:	TE or not TE
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<sup>33</sup> Section 235-2 numeral 5.

				Unclear whether to reform or not	
Tax provisions targeted at the agricultural sector		<ul style="list-style-type: none"> <li>Coffee growers' labour costs</li> <li>Investments in listed agricultural firms</li> </ul>	<ul style="list-style-type: none"> <li>Perennial crops (pre-2014)</li> <li>Productivity enhancing investments</li> <li>VAT Exclusions</li> <li>Agricultural tourism</li> </ul>		<ul style="list-style-type: none"> <li>Incentives for rural capitalisation.</li> <li>Forestation subsidy</li> </ul>
ZOMAC and ZESE		ZOMAC ZESE			

### Category II includes:

- **Coffee growers' labour costs:** see discussion in section 5.6
- **Investments in listed agricultural firms:** the justification for this preferential tax treatment is weak.
- **ZOMAC:** see discussion in section 5.6
- **ZESE:** see discussion in section 5.6

### Category III includes:

- **Perennial crops (pre-2014), and productivity enhancing investments in the agricultural sector:** see discussion in section 5.6. While it might not be feasible to take away the tax incentives that have been given in the past, government should ensure that the mistakes of the past are not repeated. Profit-based tax incentives should be avoided.
- **VAT exclusions:** the VAT exclusion of agricultural products have been discussed in the VAT note. The agricultural sector could be brought within the VAT, in particular when poor people can be compensated for the VAT they pay on the food they buy.
- **Agricultural tourism:** preferential tax rate for agricultural tourism, or any other sector, should be avoided. The tax system should become more attractive for all businesses.

## 5.6 Identifying Reform Priorities for Tax Expenditures on Non-taxable Income and Tax Benefits for the Countryside

### Deemed workforce cost for coffee growers

Rather than deducting the actual labour costs, coffee growers have a deemed tax-deductible workforce cost equivalent to 40% of taxable income. This incentive was created because the workforce of coffee growers is largely informal and comprised mostly of independent workers. In Colombia, labour costs are normally only tax deductible if the employee and their employer make pension and health insurance contributions and if the worker is registered before the Tax Authority. As the workforce in the agricultural sector is highly informal, these conditions are typically not met and so the employer foregoes the deduction of the wage cost.

This tax provision is a TE as it provides a tax deduction that would, in other circumstances and for other businesses, be disregarded by the tax administration. It also generates large negative external effects as it takes away the incentive and obligation for employers to hire workers in the formal sector. This TE should



be abolished and employers should be encouraged to organise their activities in such a way that their workers enter the formal economy, and contribute to, as well as benefit from, health and pension entitlements. Most smallholder coffee growers are likely to earn revenue below the turnover threshold of the SIMPLE regime. For those coffee growers with revenue above the UVT 80 000 ceiling (approximately US\$ 800 000), the current workforce cost deductions represent an unfair competitive advantage that distorts the functioning of the market.

### **Tax benefits for the agricultural sector**

The agricultural sector receives a preferential tax treatment, in the form of profit-based tax incentives, which has been applied in an attempt to compensate for the underlying challenges the sector faces. However, profit-based tax incentives are a poor instrument to tackle these challenges, which include poor quality infrastructure and the limited development of the sector. Rather than using the tax system, the challenges need be tackled at source.

That being said, abolishing the preferential tax treatment of the agricultural sector and taxing it as other sectors are taxed might result in a strong increase in the tax burden. This could, in turn, incentivise the sector to operate (even) more regularly within the informal economy. Reforming the tax incentives provided to the agricultural sector is therefore conditional upon broader reforms that increase the productivity of the sector and improve infrastructure, amongst other priorities.

The formalisation of the agricultural sector should be of primary importance for the government. A key element of a formalisation strategy should be to ensure that small agricultural businesses qualify for SIMPLE. Government officials have argued that farmers already qualify for SIMPLE, but that the SIMPLE regime needs to be better promoted to (and made more accessible for) smallholder farmers. Many farmers have low turnover, significantly below the maximum turnover threshold so rather than having to face the complex regular business tax system, they would pay SIMPLE instead. This system could serve the dual purpose of increasing formalisation and, as farmers will pay health and pension SSCs once they are registered under SIMPLE, would give them access to basic social welfare provisions.

Moreover, small farmers' revenues are highly unlikely to exceed the VAT registration threshold, which prevents them from having to pay VAT. The combined impact of SIMPLE and the VAT registration threshold significantly reduces the tax burden on small farmers, and government should ensure that farmers are aware of the advantages and the functioning of the tax system, e.g. through a tax education and media strategy targeted at farmers across the country.

However, the comparatively small number of farmers that file a SIMPLE return and whose turnover is above the VAT threshold may not be able to recover the input VAT paid on investment in fixed assets as they cannot enjoy the CIT credit for VAT paid on investment (as they are liable for SIMPLE instead of the CIT). As pointed out in the previous chapter, rather than introducing another credit within SIMPLE, government should restore the functioning of the VAT and provide a timely refund for input VAT that can be credited against the VAT levied on sales.

Tax measures will have to be accompanied by a wide set of non-tax measures. One important measure would be to incentivise farmers to register their property. Government should facilitate property registration by preventing large tax and non-tax registration costs over a period of time. Other measures could be included in the government's broader plans to formalise and develop the agricultural sector.

### **Design of ZOMAC and ZESE regime**

The rural zones in Colombia face many economic challenges, and the country needs a regional development plan that tackles the key problems rural areas face. This includes poor infrastructure, a lack of good quality jobs and a labour market force with little skills, a lack of zones where investment is

attractive for investors, etc. Initiatives such as Colombia Rural, whose objective is to improve the quality of road infrastructure to allow rural communities to bring their products closer to regional markets, are a step in the right direction. International evidence shows that in these circumstances, tax incentives will not be very effective in attracting investment. The only investment project that will benefit from the tax incentives are location-specific projects and these would have occurred in the absence of the tax incentives. If government wants to use the tax system to stimulate investment, it could use cost-based incentives that reduce the cost of investment for businesses. Profit-based incentives, such as ZOMAC and ZESE, are the least preferred option.

In addition, the design of the ZOMAC regime is complex, which may reduce the transparency for investors of the conditions that need to be fulfilled in order to qualify for the tax reductions. For instance, the regime identifies 47 activities and each one of them has different requirements regarding the amount of investment and employment that need to be met.

Moreover, in order to qualify, the rules stipulate that all economic activity must be developed within the zone. For a business that operates both within and outside of the ZOMAC regime, only the profits that are linked to economic activity within the regime benefit from the reduced rate (tbc). This creates domestic tax planning opportunities and challenges for the tax administration.

## 5.8 Conclusions and Reform Options

There are significant tax base broadening opportunities with respect to the “non-taxable” income and capital gains items as well as the “exempt” income and capital gains items in both the CIT and PIT. Where a decision is taken to maintain a tax expenditure that currently takes the form of a tax allowance, consideration should be given as to whether this should be converted into a tax credit in a context in which different sectors face different tax rates. While some TEs call for immediate action, other TEs can better be addressed as part of a fundamental reform of the capital income tax system, both at the corporate and personal shareholder level.

Key examples of TEs that can be immediately reformed include the preferential tax treatment of the remuneration of a selected group of officials, which violates horizontal equity, the quasi-non taxation of pensions, and the exemption of dividend withholding tax in relation to mega investments. The undervaluation of capital gains, which are calculated on a value that differs from the market value of the assets, is a large TE. The CIT recapture tax can be easily avoided if shareholders earn capital gains instead, so if the CIT recapture tax were to be maintained (but this is not recommended by this report), its functioning might be broadened to capital gains. In addition, the value of the voluntary health, pension, housing and education payments made by employers for their workers should be included in personal taxable income and taxed under the PIT. Tackling these TEs would consist of a significant tax base broadening effort.

This chapter has identified TEs that have remained somewhat under the radar such as, for instance, the under-valuation of property and assets as part of the tax base. In order to ensure transparency, it is important that all TEs are listed and that the tax revenue foregone is presented on an item-by-item basis in the Colombian TE report.

Significant efforts have been made by the DIAN to measure the tax revenue foregone of the TEs in the categories covered in this chapter. The work should continue to present, as part of the TE report, the tax revenue foregone of all items considered as TEs under a TE benchmark on an item-by-item basis.

The division of items into the categories “non-taxable” and “exempt” income and capital gains is unique in OECD countries and it reflects the complexity of the tax system in Colombia. With the abolishment of the presumptive income tax, the distinction itself can be abolished too. The new category should be narrow in

scope in two ways. First, items that are not income should not be included. Second, as many income items as possible should be taxed, either immediately or gradually over time, under general CIT and PIT rules.

Colombia implements a wide range of tax incentives for the agricultural sector. The tax revenue foregone of these incentives is small because the sector is largely informal and operates outside of the tax system. Tax incentives targeted at the agricultural sector largely miss their objective and do not reach the businesses and farmers that need the support the most. The formalisation of the agricultural sector should be the main priority for government; this will require a well-developed formalisation strategy that includes tax and, in particular, non-tax measures and that tackles the problems of the agricultural sector at source, including through investment in infrastructure. Non-tax measures may include, for example, the formalisation of land ownership and increasing education levels in rural communities. The deemed tax-deductible workforce cost equivalent to 40% of taxable income that coffee growers benefit from needs to be abolished. The TIC welcomes that SIMPLE is available for all small businesses, including farmers. This serves a dual objective: incentivising farmers to enter the formal economy and providing access to benefit payments. Tax measures will have to be accompanied by a wide set of non-tax measures. One important measure would be to incentivise farmers to register their property. Government should facilitate such a registration by preventing large tax and non-tax registration costs. Other measures could be included in the action plan to formalise the agricultural sector.

The rural zones in Colombia face many economic challenges, and the government has recently attempted to stimulate economic growth through the introduction of profit-based tax incentives such as ZOMAC and ZESE, rather than tackling the problems at source. However, profit-based tax incentives are not the best option when economic regions lack the necessary conditions that businesses need in order to invest and earn a profit. Colombia needs a regional development plan that improves infrastructure, prepares investment zones, increases the skills of the workforce, etc. Such a plan could include cost-based tax incentives that subsidise the cost of investment rather than a system of profit-based incentives as currently is the case.

# Annex 1.C. Tax Expenditures Pertaining to Non-Taxable Income and Tax Benefits for the Countryside

## Non-taxable general income

- The value of compensation for damages in money or in kind provided from insurance;
- Assets received as a consequence of divorce are deemed as non-taxable income. However, allowances received after divorce are taxed;
- Economic support for students given by the State;
- Financial support for venture capital.
- Rewards from supply of data to the intelligence sections of the State / Government bodies (article 42 of the TS)
- Financing to political parties, Movements and campaigns (article 47-1)

## Social contributions

- Mandatory contributions made by employees, independent professionals, employers and members of the General System of Social Security of Pensions will not be part of the basis to calculate the income tax withholding and will be deemed as non-taxable income;
- Mandatory contributions made by employees, independent professionals, employers and members of the General Health Social Security System will not be part of the basis to calculate the income tax withholding and will be deemed as non-taxable income. Note that health contributions made by employees and independent professionals are a tax deduction and are included in the discussion of WP4.

## Non-taxable capital income

- Profits distributed as a result of the liquidation of a limited liability company up to the amount of the capital contribution made by the shareholder;
- Dividends received by partners, shareholders and the like when the profits being distributed were already taxed to the company distributing the dividends. For this purpose, they must meet the conditions set forth in article 48 of the Colombian Tax Code;
- Dividends and benefits distributed by a CFC, as well as the remnants distributed at the time of liquidation of the CFC, when such profits were taxed in accordance with CFC rules; dividends derived from Mega-Investments<sup>34</sup>;
- Income from the sale of shares or participations in a CFC that correspond to profits that were subject to taxation in accordance with CFC rules;
- Certificates of investment by means of new investments in the exploration of mining and hydrocarbon;

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<sup>34</sup> Income tax taxpayers that make new investments in Colombia over 30 000 000 of Tax Value Units (COP 1 068 210 000 000 = USD 289 174 337) and comply with other requirement set by the law, can qualify for the Mega-Investment regime.

- Income provided from the sale of shares of a company listed in the Colombian Stock Exchange, when such sale does not represent more than 10% of the total number of shares of the listed company;
- Profit provided from the sale of immovable property acquired since 1978 to 1986, where the percentage of non-taxable income decreases from 1978 (100% non-taxable) to 1986 (10% non-taxable);
- Inflationary component when capitalised and on interest paid by financial entities and investment funds.

### **Exempt income**

- Compensation for work-related accidents or illness;
- Maternity leave payments;
- Severance payments and interest earned on severance payments, provided they are received by employees whose average monthly salary in the previous 6 months does not exceed 350 UVTs;
- Retirement, disability, old age, survivors and professional risks pensions up to 1 000 UVTs. Pensions received from foreign pension funds do not fall under this tax exemption and they are fully taxable;
- Life insurance proceeds and death compensations of members of the army and national police;
- Amounts received in excess of the basic salary by officers, sub-officers and professional soldiers of the military forces, and officers, sub-officers, executive level, patrol officers and agents of the national police;
- As from tax year 2020, 50 percent of the salary earned by judges of second-tier courts and public prosecutors, and 25 percent of the salary earned by judges of first-tier courts;
- Representation expenses received by deans and professors of public universities, up to 50 percent of their salary;
- Voluntary contributions paid by the employer or self-employed individuals (or employees) to private pension insurance, to pension funds voluntary or mandatory, administered by entities subject to the surveillance of the Financial Supervisory. Note that the contributions paid by the employee are tax-deductible, and are therefore not included here but in the PIT tax policy note;
- Voluntary contributions paid by the employer or self-employed individuals (or employees) deposited in special savings accounts to promote construction, limited yearly to the lesser of 3 800 UVTs or 30% of total income in the year. The exemption does not apply if the funds are used for other purposes than purchasing family housing, or if the resources are withdrawn within a 10-year term if contributed or deposited from 1 January 2013 onwards;
- Education and health payments made by the employer for the benefit of the employee are not part of employment income, as long as they do not exceed the average amount allowed to the majority of employees for education and health purposes and they correspond to permanent programmes of the company for its employees;
- Payments made by the employer to employees or their families for food up to a monthly amount of 41 UVTs are exempt income of the employee. This tax treatment only applies to employees with employment income below 310 UVTs per month. There are some additional conditions that need to be met when the payment is made through vouchers;
- Exemptions on certain income from top government positions (article 206 of the Tax Code)

- Private use of a company car. Transport reimbursements are exempt from individual income tax provided that the employee provides the employer with invoices to support the reimbursement. This includes the private use of a company car made available by the employer, tickets for fuel costs and maintenance, and the payment of the insurance premium in respect of a vehicle used by the employee for work purposes.
- The government subsidizes 50% of the costs of reforestation of protective-producing plants. This income is non-taxable.

### **Preferential tax rates**

- A preferential income tax rate of 9% for new perennial crops cultivated before fiscal year 2014. The tax incentive applies for ten years after the start of the crops' production and applies to rubber, palm oil, cocoa, citrus trees and other fruit trees;
- A preferential income tax rate of 9% for the agricultural tourism sector;
- Income derived from investments that increase the productivity of the agricultural sector is exempt from income tax for the following ten years (under the condition that the investments comply with a certain set of requirements);
- Agricultural goods are VAT excluded, although some of them are taxed at a reduced 5% rate. No VAT is charged on the majority of farm inputs and agriculture outputs (both domestically produced and imported). These TEs have been discussed in the VAT Tax Policy Note.

### **Tax base subsidies**

- Coffee growers' labour costs: Rather than deducting the actual labour costs, coffee growers have a deemed tax-deductible workforce cost equivalent to 40% of taxable income;
- Tax provision for investors in agricultural companies. Taxpayers who invest in agricultural companies listed on the stock market have the right to deduct the value of the investment as a tax credit, which may not exceed 1% of their taxable income.

### **Subsidies outside of the tax system**

- Incentives for rural capitalisation;
- Forestation subsidy (Certificado de incentivo forestal). As previously described, the government subsidizes 50% of the costs of reforestation of protective-producing plants.

### **ZOMAC**

New companies established in one of the Zones Most Affected by Conflict (ZOMAC) benefit from tax rate relief for a period of 10 years; in these zones, the following rates apply:

- Micro and small companies benefit from a 0% rate for the period 2017-2021; 25% of the standard rate for the period 2022-2024 and 50% of the standard rate for the period 2025-2027.
- Medium and large companies will have preferential tax rates of 50% of the standard rate for the period 2017-2021 and 75% of the standard rate for the period 2022-2027.

### **ZESE**

Preferential tax regime for Economic and Social Special Zones (ZESE); 0% income tax rate for the first 5 years and 50% reduction in the standard tax rate for the following 5 years. The preferential tax treatment applies to the following departments: La Guajira, Norte de Santander and Arauca, and the Capital Cities of Armenia and Quibdó, which are the departments with the highest unemployment rates in the country. All commercial corporations that are created within three years following the entry into force of the law (May

25, 2019) are eligible as well as all commercial corporations that were already active in the departments before the law, but companies must demonstrate that they have increased (and maintain) their labour force by 15 percent. The main business activity must be the development of industrial, agricultural, commercial, tourism or health activities; all economic activity must be carried out within the ZESE.



# Working Party 4: Individuals, Employment and Dividends

Tax Expenditures Report





## 6. Working Party 4: Individuals, Employment and Dividends

*The effective tax rates (ETRs) that individuals pay on their employment income, personal business income and capital income in Colombia are very low. This chapter identifies and analyses the numerous factors that explain these low ETRs. Among them are very generous and regressive tax deductions, a wide range of tax exemptions, large brackets in the personal income tax (PIT) rate schedule, a generous basic PIT allowance, the near-total tax-exemption of pensions, and low rates on capital gains and dividends. Overall, there is ample scope for reform. DIAN simulations indicate that a significant broader PIT base would allow raising approximately 2% of GDP in additional PIT revenues while allowing for a significant reduction in the PIT rates. This reform would also reduce distortions and restore fairness, while ensuring that effective tax rates remain low. With respect to the tax treatment of pensions, the government should limit the deduction of pension savings from general taxation or tax income from pensions jointly with labour income. Remuneration paid by employers to their employees in the form of pension, health, education or other types of fringe benefits should be included in taxable income.*

*The TIC also finds that the design of several of Colombia's tax allowances is very regressive. Not only does the ceiling of the tax deduction increase with the income of the taxpayer, but the value for the individual (and the fiscal cost for government) of the tax deduction itself also increases with the taxpayer's marginal tax rate. In addition, most of the TEs are enjoyed only by higher-income households. Despite its progressive PIT rate schedule, the design of the Colombian PIT system is unfair. The TE ceiling, which is equal to 40% of net taxable income or 5 040 UVTs (whichever is lower), serves as a base protection measure, but the design of the ceiling is regressive as it increases with income. The TIC recommends eliminating the TE ceiling if the PIT base is broadened, as suggested, but ensuring that all voluntary contributions fall under the ceiling's scope if the PIT base remains narrow. To prevent abuse of TEs by the self-employed the TIC supports the existing provision that business expenses need to have been paid electronically and be verifiable with an invoice to be tax deductible, and recommends that the government enforces the monitoring of these expenses. The design of the taxes on personal capital income can be improved; for instance, the tax exemption for listed shares could be removed over a transitional period of up to five years. The tax residency rules should be reviewed and, possibly reformed in accordance with international practice. Finally, as part of this Commission, DIAN has made significant efforts to improve its tax revenue foregone estimation methodology. These efforts should continue so that the Colombian TE report can include tax revenue foregone estimates based on individual tax returns as well as provide estimates for each TE on an item-by-item basis. Nevertheless, abolishing TEs and broadening tax bases may not necessarily result in more tax revenues as long as taxpayers can easily shift to other TEs that were not eliminated. Government should therefore envisage a reform that broadens the base significantly rather than introducing "marginal" tax reforms. Thus, while a discussion on TEs is a necessary as a first step, it is only a starting point for the discussion and preparation of a tax reform.*

### 6.1 Introduction

The Colombian tax code differentiates between different types of income. "General gross income" consists of the sum of "labour income", "capital income" and "non-labour income". "Labour income" includes salaries, commissions, social benefits, travel expenses, representation expenses, compensation received for associated cooperative work and, in general, any kind of compensation for personal services. "Capital income" is defined as income from interest, financial returns, leases, royalties and the exploitation of intellectual property. Note that "dividends" received by an individual are not part of "capital income", as

“dividends” constitute an income category in itself; the same applies to “capital gains” realised by the individual, which is referred to as “occasional income”. “Pensions” are also a separate category. Non-labour income is a residual income category that covers any income that is not considered labour income, capital income or dividends and occasional gains. Income earned by self-employed other than personal services would be reported in this category.

**Table 6.1 Determination of taxable income for the “general income” category**

<b>General gross income = sum of labour income, non-labour income and capital income</b>
Minus non-taxable income <sup>1)</sup>
<b>= General net income</b>
Minus exempt income <sup>2)</sup> and special deductions <sup>3)</sup> (up to 40% of general net income and max 5 040 UVT per year) <sup>4)</sup>
Minus costs incurred to earn non-labour income and capital income
<b>= Taxable income</b>

Notes: 1) Non-taxable income: Includes voluntary contributions if these contributions are made to the pension funds that manage also the mandatory pension contributions. 2) Exempt income: contributions to voluntary pension schemes, contributions to AFC housing savings (max 30% of general gross income and up to 3 800 UVT). 3) Special deductions (art 387): Support of dependants (max 10% of gross income and 32 UVT monthly), payments for food, private health payments, 50% GMF financial transactions tax. Since November 2020, independent workers cannot benefit from these deductions. 4) Deductions and exempt income up to 40% of total net income (from all types of income labour, capital and non-labour): some tax expenditures are not subject to this ceiling.

“Non-taxable income” is deducted from “general gross income” to obtain “general net income”. The sum of exempt income plus deductions cannot exceed 40% of general net income, up to a ceiling of 5 040 UVT per year (about USD 48 000, COP 179 million). However, this ceiling does not apply to non-taxable income. The 40% ceiling is also available for unincorporated businesses (including liberal professions such as lawyers and accountants) with a maximum of two employees. These businesses can choose to either have 25% of their income exempt, or deduct effective costs. If they choose the 25% exempt labour income, they are also obliged to observe the 40% net income ceiling, as is the case for employees, while if they choose to deduct effective costs, deductions can exceed the 40% ceiling.

“General net income” reduced by the taxpayer’s “exempt income” and “tax deductions”, taking into account the deduction ceiling, and net of the costs associated to non-labour and capital income, yields “taxable income”, to which the tax rate schedule is applied, which yields “gross tax liability”. “Net tax liability” then equals gross tax liability net of the tax credits that can be claimed.

Taxable income, including “capital income”, is taxed at the PIT rate schedule. The PIT rate schedule in Colombia is progressive with seven tax bands and gradually increasing tax rates of 0%, 19%, 28%, 33%, 35%, 37% and 39%, with wide taxable income bands. The highest rates start applying at very high incomes. The PIT rate schedule has a zero-rate bracket for taxable income below 1 090 UVT (about USD 10 500, COP 39 million), which is particularly high in the international comparison. This basic tax allowance (or 0% rate band) is typically not considered a TE in OECD countries. However, it might be of interest to calculate the revenue forgone associated to it (i.e. forgone revenue assuming a benchmark in which the 0% rate bracket would not exist and income in this bracket would for example be taxed at 19%).

Dividends, capital gains and pensions are taxed at three separate tax rate schedules. If dividends are paid out of profits that were not taxed under the CIT, they are first taxed at a withholding tax rate that equals the CIT rate (i.e. 31% in 2021 and 30% as from 2022 onwards). This withholding tax is not levied, however,

if dividends have been paid out of profits that were taxed under the CIT. Thereafter, dividends are taxed under a dividend withholding tax with a rate of 10% levied on distributed dividends exceeding 300 UVT. (See also WP2 for more details). Occasional capital gains are also taxed at 10%. Pension income is taxed separately and benefits from a very generous tax allowance (UVT 1 000 monthly, approximately USD 9 555). For this reason, hardly any pensioners pay income tax.

### **The weaknesses in the design of the PIT are reflected in the income distribution**

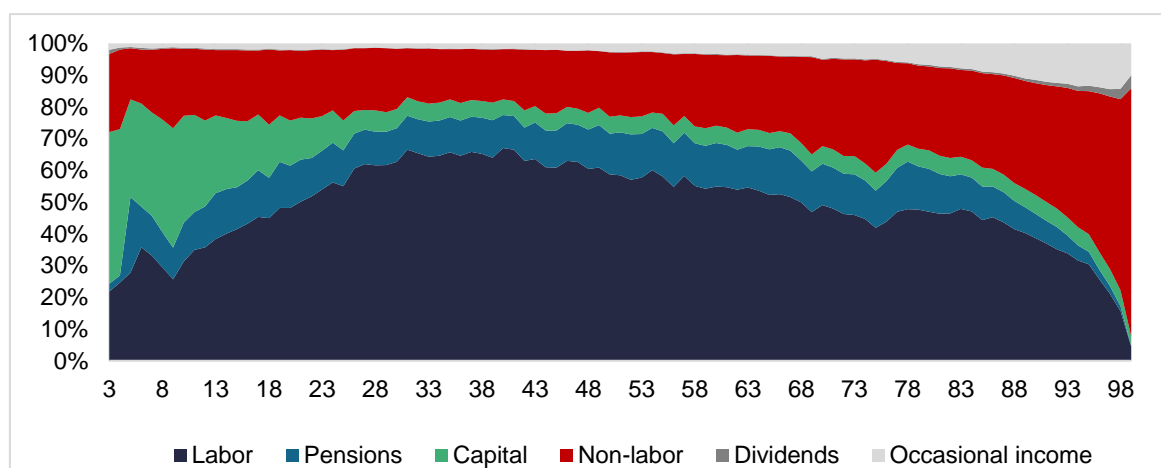
Figure 6.1 shows the types of gross income earned by individual taxpayers that file a PIT return across the personal income distribution. While an in-depth evaluation goes beyond the scope of this Report, the data does point at a number of key observations that are at the core of the TIC report, and which call for fundamental PIT reform and stronger tax enforcement.

First, taxpayers in the first quartile report a larger share of capital income than the rest of the distribution. To better understand this finding, it should be noted that taxpayers are required to file a tax return only when their gross income exceeds 1 400 UVT (COP 46.4 million in 2018). In 2018 this threshold was situated above the first quartile of taxpayers. Taxpayers earning income below 1 400 UVT only file a tax return if they expect to obtain a tax refund (i.e. the amount withheld at source exceeded their final tax liability). The fact that taxpayers in the first quartile report a large share of capital income may reflect that the inflationary component in capitalised income and interest is non-taxable. The withholding tax is applied on nominal interest and the inflationary component is only deducted when filing the tax return. It may also reflect a statistical issue in that low-income workers who earn a salary below the tax filing threshold (1 400 UVT), but above the tax-exempt income bracket, and who do not earn other types of income may not have been included by DIAN in the data underlying the chart. The distribution of low incomes therefore needs to be interpreted with caution.

Second, the amount of dividends is extremely low across the income distribution and, in particular, at the top of the income distribution. This is in strong contrast to the income distribution in other OECD countries where richer taxpayers earn a larger share of their income in the form of capital income (including dividends and capital gains). The low level of dividends is related to the tax-induced incentive that businesses face not to distribute dividends, as discussed in the CIT chapter.

Third, top income earners mainly earn non-labour income (i.e. entrepreneurial business income including income from liberal professionals with more than two employees that is taxed under the PIT). The large share of personal business income means that the majority of the entrepreneurs have not incorporated their business, as is the case in most other OECD countries, but prefer to operate under the unincorporated business form. The low ETRs on personal business income, in contrast to the high overall statutory tax burden on capital income, is likely a key driver of this finding.

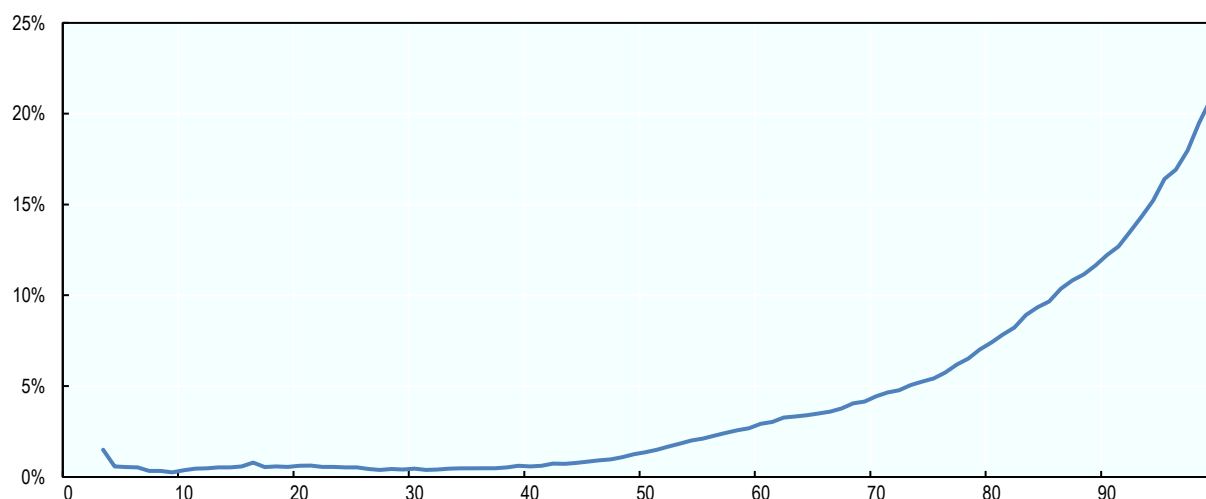
**Figure 6.1 Distribution of gross income by individuals that file a PIT return across the personal income distribution, 2018**



Source: DIAN. PIT tax returns of fiscal year 2018. Ministry of Finance calculations.

### Effective PIT rates are low

**Figure 6.2 Effective PIT liability of as a percentage of taxable income considering all types of income by percentiles of taxpayers, 2018**



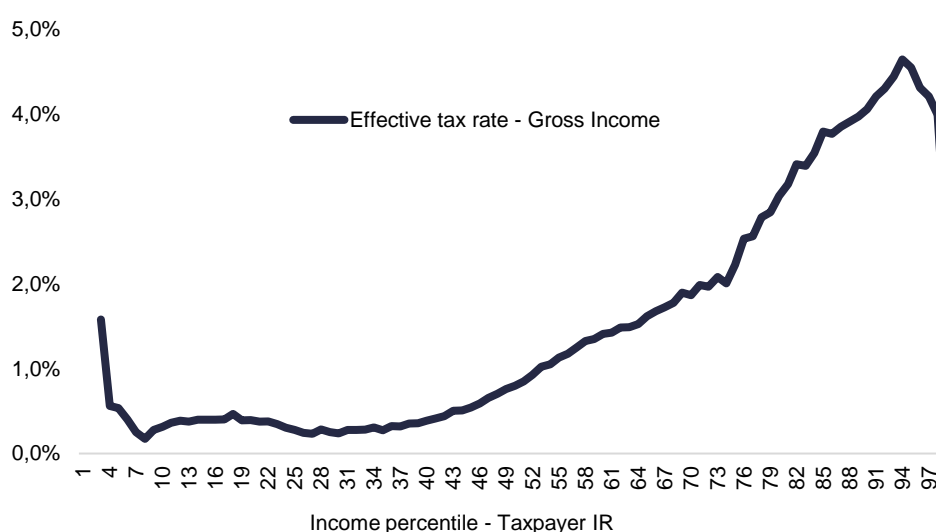
Source: DIAN and MOF, individual tax returns for the 2018 fiscal year.

Note: Effective rates are only calculated for taxpayers and not for the entire population.

The effective PIT rates in Figure 6.2 show the final PIT liability as a percentage of the sum of all taxable income across the taxable income distribution in Colombia; i.e. for all types of income, including general income (i.e. labour income, capital income and non-labour income) augmented by dividends, pensions, and occasional income/capital gains. Effective PIT rates, when calculated in this way, capture the combined effect of the total tax liability, the level of taxable income across the taxable income distribution, the design of the PIT rate schedule and the specific tax rates that apply to “non-general” income as well as the PIT credits. The value of other TEs (non-taxable income, exempt income and additional deductions) are not included in the denominator of the ETR. Effective PIT rates remain low across almost the entire taxable income distribution, and the ETRs that are paid in the top decile are significantly below the top statutory PIT rates. This indicates that the tax bands in the PIT rate schedule are very wide and/ or that richer households earn types of income, such as dividends and capital gains that are taxed at lower rates.

Figure 6.3 shows the distribution of effective tax rates, calculated as net tax liability as a percentage of the sum of all types of gross income; that is before non-taxable income, exempt income and deductions are deducted. Effective tax rates are very low because of generous TEs. In fact, the ETRs do not increase above 2% up to the seventh decile and then gradually increase to slightly above 4% before dropping to about 2% for the top 1% richest taxpayers in Colombia. The drop in the effective tax rate at the top of the income distribution is partly explained by the increased share of non-labour income (i.e. self-employed business income). Although this income is taxed at the regular PIT rate schedule, the high statutory PIT rates do not result in an increase in effective tax rates due to the subtraction from taxable income of incurred costs that can exceed the 40% net income ceiling.

**Figure 6.3 Effective tax liability on income earned at the individual level as a % of total income, 2018**



Source: Dian and MOF, individual tax returns for the 2018 fiscal year

Note: Effective rates are only calculated for taxpayers and not for the entire population.

### The 1990 OECD personal income tax base classification

As described in its 1990 report, “The Personal Income Tax Base, a Comparative Survey”, the OECD applies a somewhat different standard classification than the one applied in Colombia. The OECD refers to “total income” as the sum of “gross income” and “other income items”. “Other income items” include illegally non-reported income and other income items such as the Colombian “non-taxable income” category. “Gross income” net of “exempt income” yields “income subject to tax”. Non-taxable income and exempt income are similar in that they cover the types of income that do not have to be added to “income subject to tax”. “Income subject to tax” net of all “tax deductions” then yields “taxable income”. The “tax deductions”, which the OECD refers to as “tax allowances”, are divided into “standard tax allowances” and “non-standard tax allowances”. Standard tax allowances are available to all individual taxpayers; non-standard tax allowances depend on specific actions that are undertaken by the household; for example, taking a loan to buy a house might entitle the individual to mortgage interest tax relief.

The analysis in this report applies the OECD classification. The income rules and tax provisions that drive a wedge between “total income” and “income subject to tax” are discussed jointly. The WP3 note therefore focuses on both non-taxable income and exempt income. The tax policy note prepared by WP4 will focus on the standard and non-standard tax allowances that individuals can claim.

### The SIMPLE regime

The SIMPLE is an alternative tax regime that since 2019 is offered to individuals such as free professionals, and unincorporated businesses who earn gross income below 80 000 UVT per year (about USD 771 000). The SIMPLE is levied on business turnover at rates ranging between 1.8% and 14.5% depending on turnover and the sector the business operates in. The SIMPLE replaces the income tax and the Municipal Business Turnover tax (ICA), in accordance with the rates determined by the municipal and district councils. Furthermore, taxpayers declare VAT and consumption tax (levied on sales of restaurants and bars) in the same tax return, but the SIMPLE does not replace both of these taxes. Qualifying taxpayers with gross income below 3 500 UVT (about USD 34 000) that are registered with the SIMPLE, are excluded from the VAT. Additionally, employer pension contributions can be credited against the SIMPLE. However, the SIMPLE does not apply to non-taxable income and exempt types of income. As the tax base is turnover, it does not allow the deduction of actual business costs or other deductions. A more in-depth discussion is included in the CIT chapter.

## 6.2 Tax Expenditures on Individuals, Employment and Dividends

Colombia has a wide range of tax deductions and credits that apply to general income, pensions, dividends and capital gains. This section lists a number of the most important tax allowances and then discusses whether there is scope for reform.<sup>35</sup>

### Individual taxpayers can deduct the following tax allowances from general income:

Standard tax allowances within the “general income” category:

*Health and pension SSCs:* Mandatory health and pension social security contributions made by employees or independent professionals (i.e. the self-employed);

*Labour income deduction:* 25% of labour income is deductible; this deduction cannot be higher than 2 880 UVT per year.

*Dependent support deduction:* Tax deductions for the support of dependents<sup>36</sup>; with a ceiling of 10% of general gross income and 384 UVT per year.

*Exceptions to exempt income and deductions ceiling:* The 40% ceiling of total exempt income and deductions that can be claimed, with an absolute value of 5 040 UVT, does not have to take into account the following items, or does not apply in the following circumstances (non-exhaustive list):

- Social benefits received by the members of the Military or the National Police while being in active duty or retirement;
- Excess of basic salary received by officers, non-commissioned officers, and professional soldiers of the Military;
- Excess of basic salary received by officers, non-commissioned officers, executive level personnel, patrolmen and agents of the National Police;
- Representing expenses of headmasters and professors at public universities, which may not exceed 50% of their salary;

<sup>35</sup> A more complete list of the TEs pertaining to individuals, employment, pensions and dividends is available in the annex of this chapter. Importance is judged against a number of criteria, including the value of foregone revenue, distortive impact, distributional impact and complexity.

<sup>36</sup> Dependents include, for example, children who are minors, children between 18 and 23 who are studying in higher education institutions, or dependent parents or siblings of the taxpayer

- In the case of judges of the High Courts, their prosecutors and judicial attorneys, a percentage equivalent to 50% of their salary will be considered exempt representation expenses;
- For judges, the exemption percentage will be 25% of the salary.

Personal business income-related standard tax allowances:

*Business expenses deductions*: Self-employed individuals can deduct all costs and expenses incurred in their business (i.e. they are not limited to the 40% deduction ceiling).

Non-standard tax allowances within the “general income” category:

*Private health insurance contributions*: Voluntary payments for additional health insurance paid to private health insurers that provide supplementary services to mandatory health insurance, to protect the worker, his partner, his children and dependents. The tax deduction cannot exceed 192 UVT per year.

*Savings contributions*: Voluntary contributions to the mandatory individual savings scheme are non-taxable income (so they are not limited to the 40% overall deduction ceiling), but the deduction itself cannot exceed 25% of general gross income, nor 2 500 UVT.

*Private contributions*: Voluntary contributions to private pension funds made by the employee and contributions to housing savings (AFC accounts) are considered exempt income. The deductions are subject to permanence requirements and cannot exceed 30% of general gross income and cannot exceed 3 800 UVT (approximately USD 37 000)

*Mortgage interest relief*: Mortgage interest relief; the deduction is limited to 1 200 UVT per year.

*Capital income costs*: Costs and expenses incurred to earn “capital income” are tax deductible. They are not limited to the 40% deduction ceiling.

*Donations*: Donations to the General Gustavo Matamoros D'Costa Corporation and to foundations and organizations dedicated to the defence, protection and promotion of human rights and access to justice, amateur sports organizations, sports clubs, sports federations or associations, and the Colombian Olympic Committee, and the recreational or cultural organizations can deduct 125% of the value of the donation.

### **Individuals that receive a pension can benefit from the following tax deductions:**

*Tax exempt pension income*: Pension income below 1 000 UVT per month or 12 000 UVT per year (about USD 116 000 per year) is tax exempt (i.e. there is a tax allowance of 12 000 UVT per year);

*Pensioners' health SSCs*: Mandatory health SSCs paid by a pensioner are deductible.

### **Tax allowances under the dividend income schedule:**

*Dividends (below 300 UVT)*: Dividends paid to an individual shareholder that do not exceed 300 UVT (about US 2 900) are not taxed under the 10% dividend withholding tax. (If the taxpayer receives dividends from different firms that have not been taxed under the dividend withholding tax in excess of 300 UVT, the excess will have to be declared as part of the annual tax return).

### **Tax allowances under the occasional income category (i.e. capital gains)**

In addition, the realised capital gains on fixed assets owned for a minimum of two years or other occasional income may benefit from a tax deduction. The tax law specifically states that the following capital gains

are exempt (see the tax policy note of WP3 for a more in-depth discussion, including on the valuation of properties and assets):

*Life insurance compensation*: Life insurance compensations are exempt, up to 12 500 UVT (about USD 120 000), compensations in excess of this amount are treated as occasional income;

*Real estate capital gains*: Realised capital gains from the sale of homes, up to 7 500 UVT (about USD 72 000);

*Heirs' inheritance (first 7 700 UVT)*: The equivalent of the first 7 700 UVT (USD 74 000) of a rural property and the equivalent of the first 7 700 UVT in the inheritance, regardless of the number of heirs;

*Heirs' and spouse's inheritance allowance (first 3 490 UVT)*: The equivalent of the first 3 490 UVT (USD 34 000) of the value of the allowances that each of the heirs and the surviving spouse received;

*Inheritances of non-heirs and non-spouses*: 20 percent of the value of the assets and rights received by individuals other than the heirs and/or the surviving spouse for inheritances and bequests, and 20% of the assets and rights received for donations and other acts, limited to 2 290 UVT (USD 22 000);

*Property valuations*: The value of transferred property is based upon the historical cost and not the current market value of the property.

### Tax deductions under the Simple Regime (RST)

*RST*: The RST in itself;

*RST credit for employer pension SSCs*: Tax credit for employer pension SSCs that reduces RST liability;

*VAT registration threshold*: The VAT registration threshold (turnover below UVT 3 500).

### The tax base is narrow: available data

Table 6.2 presents the tax revenue foregone of selected TEs on an item-by-item basis, estimated by DIAN for the purpose of this report. However, the methodology applied to estimate these figures differs from that of the MFMP. While these recent item-by-item estimates have been calculated by means of microsimulation applying the PIT schedule to individual tax returns, the MFMP applies average marginal rates to the different income. Furthermore, 2019 figures published in the MFMP 2020 are projections from 2018 tax returns using nominal GDP growth. Together, all these factors explain why the summary measure of tax allowances and exempt income deducted up to 40% of net income exceeds the total amount reported in the MFMP 2020. These item-by-item estimates are preliminary and estimations should be further refined as part of the ongoing work of DIAN.

**Table 6.2 Forgone revenue from selected items in personal income,**

	2018	
	COP thousand million	% of GDP
Exempt income and special deductions up to 40% of net income <sup>1</sup>	10 433	1.06
Exempt income from pensions <sup>2</sup>	3 739	0.38



Exempt dividends (300 UVT) <sup>3</sup>	34	0.00
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Notes: (1) Figure corresponds to box 36 of Form 210 - Fiscal Year 2018, for positive values in box 32 "Gross income from labour relationships". The value of box 36 cannot exceed 40% of the net income nor can exceed 5 040 UVT. This item was estimated at the individual level by adding this income to taxable income and applying the PIT rate schedule. (2) This item was estimated at the individual level by adding this income to taxable labour and pension income and applying the PIT rate schedule. (3) Information on exempt dividends was extracted from individual tax returns. Forgone revenue was estimated applying a 15% rate to exempt dividends. Revenue forgone from this item is expected to increase significantly in 2019.

Source: Coordinación de Estudios Económicos. SGAO, DIAN

Table 6.3 reports exempt income and tax allowances as well as non-taxable income by type of income in the individual tax return; note that the figures represent foregone taxable incomes instead of forgone tax revenues. To estimate fiscal cost these items should be added to taxable income, the progressive PIT schedule should be applied, and then the amount should be subtracted by the actual PIT liability. Non-taxable income is currently not considered a TE by DIAN and that is not aligned with the approach that the TIC suggests to follow. While some items should not be considered as TEs such as mandatory social security contributions, other non-taxable income items are clearly a TE such as the non-taxation of income from the sale of shares of companies listed in the Colombian Stock Exchange.

**Table 6.3 Exempt income and non-taxable income by type of income, COP thousand million**

Income type	Exempt income and tax allowances (2018)	Non-taxable income (2019) <sup>1</sup>
Labour income	45 640	12 017
Pension income	27 009	3 011
Capital income	140	708
Non-labour income	258	3 549
Income from dividends and shares	50	3 211
Income from occasional gains <sup>2</sup>		4 067

Source: Personal Income Tax Returns, Coordinación de Estudios Económicos. SGAO, DIAN

Notes: (1) Non-taxable income is currently not considered a tax expenditure by DIAN. (2) In the PIT return for the 2019 FY, the concepts of occasional non-taxed income and occasional exempt income are included in the same box. The value reported in this table corresponds to this aggregation.

Table 6.4 reports 2019 projected exempt income from selected items based on 2016 tax returns. Some figures are particularly low, such as the deductions of mortgage interest tax relief, which seems to indicate that the corresponding tax revenue foregone is very low. These TEs will have to be confirmed by DIAN in its future TE report.

**Table 6.4 Selected exempt income items (not revenue forgone) in 2019, COP thousand million**

Exempt Income Items	Value
Exempt income from voluntary contributions to pension funds	1 863
Exempt income from voluntary contributions to housing saving accounts (AFC)	2 993
Deductions from mortgage interest payments	3 148

Source: Coordinación de Estudios Económicos. SGAO, DIAN

Note: Information for 2016 adjusted to 2018 and 2019 considering nominal GDP growth.

## 6.3 Categorisation of Tax Expenditures

The most important non-taxable income items are assigned into four TE reform categories:

- Category I: no reform is recommended/ needed
- Category II: TE base-broadening reform is desirable
- Category III: reform might be possible over time conditional upon the implementation of accompanying tax reforms
- Category IV: whether or not to reform the TE requires further analysis, but the tax revenue foregone of the TE should be measured and the TE should be assessed

In addition, Table 6.5 below includes a fifth column that signals whether there is genuine doubt whether the non-taxable income item is actually a TE or not.

This tentative categorisation takes into account the following dimensions:

- The tax revenue foregone;
- The distributional implications, in particular if the TE has a significant regressive distributional impact;
- The efficiency implications;
- The impact on the complexity of the tax system, the extent to which the TE creates tax planning and avoidance opportunities, and the extent to which the TE creates challenges with respect to its administration, compliance and enforcement.

Table 6.5 provides a non-exhaustive list of TEs regarding to individuals, employment and dividends, as some TEs have been discussed in the tax policy note of WP3 that discusses non-taxable income and exempt income. The note of WP2 on the CIT discusses TEs in relation to the CIT recapture tax..

**Table 6.5 – Categorisation of Tax Expenditures**

	<b>Category I: No reform</b>	<b>Category II: Reform is desirable</b>	<b>Category III: Reform is conditional</b>	<b>Category IV: Unclear whether to reform or not</b>	<b>TE or not TE: that's the question</b>
General income	<ul style="list-style-type: none"> <li>• Health and pension mandatory SSCs</li> </ul>	<ul style="list-style-type: none"> <li>• Labour income deduction (25%)</li> <li>• Exempt income and deductions ceiling</li> <li>• Exceptions to exempt income and deductions ceiling</li> <li>• Private pension and health contributions (exempt income)</li> <li>• Preferential saving accounts (including AFC and AVC)</li> <li>• Mortgage interest relief</li> <li>•</li> </ul>		<ul style="list-style-type: none"> <li>• Business expenses deductions</li> <li>• Private health insurance contributions</li> <li>• Capital income costs</li> <li>• Taxation of real versus nominal return of interest income and other types of financial returns</li> <li>• Dependent support deduction</li> </ul>	<ul style="list-style-type: none"> <li>• (Health and pension SSCs)</li> <li>• (Business expenses deductions)</li> <li>• (Capital income costs)</li> <li>• (Taxation of real versus nominal return)</li> </ul>

Pensions	<ul style="list-style-type: none"> <li>• Pensioners' health SSCs</li> </ul>	<ul style="list-style-type: none"> <li>• Tax exempt pension income</li> </ul>			
Dividends				<ul style="list-style-type: none"> <li>• Dividends (below 300 UVT)</li> </ul>	
Occasional income		<ul style="list-style-type: none"> <li>• Undervaluation of immovable property gains (see WP3 note)</li> <li>• Undervaluation of inheritances (see WP3 note)</li> <li>• Undervaluation of donations (see WP3 note)</li> <li>• Undervaluation of fringe benefits, including goods received</li> <li>• Life insurance compensation (see also WP3)</li> </ul>	<ul style="list-style-type: none"> <li>• Profits from the sale of shares registered in the Colombian stock market</li> </ul>	<ul style="list-style-type: none"> <li>• Real estate capital gains</li> <li>• Heirs' inheritance (first 7 700 UVT)</li> <li>• Heirs' and spouse's inheritance allowance (first 3 490 UVT)</li> <li>• Inheritances of non-heirs and non-spouses</li> </ul>	
SIMPLE	<ul style="list-style-type: none"> <li>•</li> </ul>		<ul style="list-style-type: none"> <li>• RST credit for employer pension contributions</li> </ul>		<ul style="list-style-type: none"> <li>• (RST)</li> </ul>

#### Category I includes:

- **Mandatory health and pension SSCs and pensioners' health SSCs:** employee SSCs are deductible in most OECD countries. This deduction is often part of the benchmark and therefore not considered as a TE.
- **SIMPLE:** see the discussion in Chapter 2.

#### Category II includes:

- **Labour income deduction:** the PIT rate schedule in Colombia has a (generous) zero-rate bracket, which significantly weakens the argument to exempt 25% of labour income from tax (with a maximum of 2 880 UVT). Moreover, this TE is double regressive as the amount of the TE is increasing with earnings, and the value of the TE is increasing in the taxpayer's marginal PIT rate. A simple example demonstrates this double regressive effect. A low-income earner who earns 100 and faces a marginal tax rate of 10% can deduct 25 pesos, which yields a tax value of 2.5 pesos (10% multiplied by 25). A high-earner who earns 1 000 and faces a marginal PIT rate of 30% can deduct 250 pesos, which reduces tax liability with 75 pesos (i.e. 250 times 30%). Colombia should aim at both reducing the basic PIT allowance (1 090 UVT) and abolishing the deduction of 25% of labour income (the 25% deduction has an economic ceiling of 240 UVT monthly and 2 880 UVT yearly). In the short term, however, a more gradual reform could maintain the 25% income deduction and its monthly ceiling. Such an approach could help foster political support to significantly broaden the PIT base.
- **Exempt income and deductions ceiling:** not accounting for exceptions (see below), the 40% of income ceiling is in itself not a TE as it imposes a limit on the TEs that can be claimed. However, the fact that the ceiling increases with income – i.e. it provides a larger ceiling to

higher incomes – is regressive by providing a larger tax subsidy to higher incomes. The ceiling itself can be reformed, as part of a reform that broadens the tax base.

- **Private pension and health contributions:** the deductions of private pension savings and health contributions from taxable income can be found in many OECD countries, but the Colombian approach to implement two TEs for private pension savings (the first, voluntary contributions to the mandatory individual savings scheme are deducted as non-taxable income; the second deduction as exempt income) seems excessive. The deduction in Colombia is very generous and it is highly regressive. Moreover, the pension that is received is largely untaxed, which in practice result in an “exempt-exempt-exempt” (“EEE”) tax treatment, which is uncommon and calls for reform. The tax deduction results in negative METRs on private pension savings, which are more negative for higher incomes, as explained in the next section.
- **Preferential saving accounts (including housing savings AFC and AVC).** This TE is rather uncommon across the OECD. In addition, the tax deduction cannot be seen in isolation from the fact that the principal amount and the return to savings when withdrawn from the savings account are not taxed, which results in an “exempt-exempt-exempt” (“EEE”) tax treatment.
- **Exceptions to exempt income and deductions ceiling:** income exemptions not subject to the 40% ceiling (e.g. 50% of income from judges of the High Courts, their prosecutors and judicial attorneys; see Section 6.2) should be abolished as they create inequities in the tax system.
- **Mortgage interest relief:** This is another generous tax deduction. Many OECD countries are gradually moving away from generous mortgage interest relief as most countries do not tax the actual or imputed income of owner-occupied or rental income. The provision is regressive, in a similar way as described before. It is recommended to include a distributional analysis of the TE in the TE report.
- **Tax-exempt pension income:** the deduction for pensions up to an amount of 12 000 UVT from taxable income is very generous, also because the pension contributions themselves were deductible from general income when they were made. This EEE treatment exempts pensions largely from tax.
- **Undervaluation of property, assets and goods received:** Property, asset and goods valuations, including for donations and inheritance tax purposes, are based on historical cost values or allow taxpayers to declare a value below the market value of the property. There is scope for reform to move towards market-based valuation as the tax base. See also the Working Party 3 note for an in-depth discussion. Goods that are received (fringe benefits) should be valued and taxed at the market value at the time of the delivery. The government has the right to purchase the property at the undervalued price that the tax payer declares. The government can deter the undervaluation of property by starting to purchase undervalued properties, to induce taxpayers to declare the actual market value, and communicating these sales to the public so the threat of purchase is real. Furthermore a geo-referenced property database could be created, that, together with a cadastral update process, identifies the market value of properties according to their location and fair market value. Establishing a price reference list would also help in this regard. In order to combat aggressive tax planning, it is advisable that the areas of the tax code that currently allow for the self-valuation of property after its purchase are removed.
- **Life insurance compensation (see the WP3 note for an in-depth discussion):** Whether or not life insurances pay-outs should be taxed below the current threshold of UVT 12 500 depends on how the saving contributions and the return earned by the insurance company have been taxed; i.e. does the benchmark follow an EET or a TTE approach. Once such an approach is chosen, it should be applied consistently for all pay-outs (so without a ceiling). Moreover,

countries often include the life insurance payment within the inheritance tax. In the majority of countries that levy an inheritance tax, life and accidental death insurance are included in the inheritance tax base.

#### Category III includes:

- **Profits from the sale of shares registered in the Colombian stock market** are considered not taxable income when the sale does not exceed the 10% of the shares in circulation of the respective corporation. Some members of the Working Party preferred to include the removal of this TE as part of a broader capital reform that is needed.
- **SIMPLE credit for employer pension contributions:** this provision implies that entrepreneurs effectively do not pay employer pension contributions if they have a sufficiently high SIMPLE liability. While this tax credit might be perceived as being generous, it cannot be evaluated in isolation but should be seen in the context of the SIMPLE and its objectives to formalise small businesses. See the in-depth discussion in Chapter 2. In the medium term, and conditional on SIMPLE significantly increasing the number of taxpayers registered under this regime, this tax credit could be re-evaluated.

#### Category IV includes:

- **Business expenses deductions:** the tax treatment of self-employed business income varies across countries. Overall, a strong case can be made to allow for the deduction from “income subject to tax” of the costs incurred in carrying out a business. However, such a deduction might allow entrepreneurs to deduct also private costs (e.g. to finance private consumption through their business). Preventing this type of tax abuse requires a strong tax administration. DIAN may want to study the amount of business expenses that are deducted by the self-employed, and develop a tool that signals when the costs that are deducted are beyond the average amount that is deducted by businesses operating in the same sector.
- **Private health insurance contributions:** the total deduction seems limited; a distributional analysis of who benefits from this TE would be useful information to be included in the TE report.
- **Capital income costs:** this deduction is somewhat unusual for individuals; a similar tax treatment for employment income does not seem to be in place, so it is unclear why workers cannot deduct all costs they incur in earning their remuneration while individuals who earn “capital income” can deduct all costs incurred.
- **Taxation of real versus nominal return:** It remains an open question to which extent the tax exemption of the inflation component in the nominal return on interest income is a TE. In order to decide upon this, Colombia needs to define a TE benchmark first. If the TE benchmark would tax only the real return on savings, then tax exemption for inflation in the return on interest income is not a TE. However, the fact that the nominal rather than the real return on equity income is currently taxed would then constitute a negative TE, as the return on equity is over-taxed. On the other hand, if the benchmark stipulates that personal capital income is taxed on a nominal rather than a real basis, then the tax exemption for the inflation component in interest income constitutes a TE.
- **Dividends (below 300 UVT):** Whether this tax provision is a TE remains an open question. The fact that it only applies to dividends and not to other forms of personal capital income seems to indicate that it does constitute a TE. On the other hand, other forms of personal capital income that are part of “general income” do benefit from a 0% rate bracket in the PIT rate

schedule. The differences in the tax treatment across different types of personal capital income supports the idea for a fundamental capital income tax reform in Colombia.

- **Dependent support deduction:** Many countries provide tax relief for families with dependents, and the deduction ceiling does not seem to be extremely large. However, it is rather uncommon to have tax allowances that increase with income (which implies that those with higher incomes are able to enjoy a larger deduction, which is not aligned with tax progressivity). The design of this TE can be improved given its regressive nature.

## 6.4 Identifying Reform Priorities for Tax Expenditures on Individuals, Employment and Dividends

### Basic tax allowance in the PIT

The design of the PIT rate schedule is a structural element of the tax system and is included in the tax benchmark; the design of the PIT rate schedule does not constitute a TE even if its taxable income bands are wide. The zero-rate band and the design of the taxable income bands in the PIT rate schedule are therefore not considered a TE. Nevertheless, the foregone tax revenue of the zero-rate band in the PIT could be measured and included in the TE report in order to inform policymakers and the public at large of the revenue implications of the specific design of the PIT rate schedule in Colombia. This estimate would show the revenue foregone by taxing the income at a 0% rate rather than at the 19% PIT rate in the rate schedule. Other estimates could be included. For instance, the tax revenue foregone by taxing income at a 0% rate band rather than at a reduced 5% or 10% rate instead, or if the width of the 0% rate bracket would be halved or reduced more.

### 40% ceiling for deductions and exempt income

The 40% ceiling on the total amount of exemptions and deductions that can be claimed, with a maximum of 5 040 UVT (around USD 49 000), is a base protection mechanism that prevents taxpayers from reducing their taxable income with more than 40% of general net income. As such, this provision is not a TE, but it is a measure that puts a limit on the total amount of TEs that can be claimed. This tax provision should be seen in light of the generous amount of TEs that taxpayers can benefit from.

The ceiling in itself is increasing in income, up to an amount of 5 040 UVT, which means that its design allows for a larger tax subsidy to higher incomes. In fact, the design is double regressive, as higher incomes can deduct more TEs but the value of the increase in the ceiling with income is increasing in the taxpayer's marginal PIT rate. Even when taxpayers reach the maximum of 5 040 UVT, its value is increasing with the taxpayer's income and marginal PIT rate.

A first best approach would be to broaden the tax base significantly by abolishing and reforming the remaining TEs. Following practice in other OECD countries, a broad PIT base would not require a ceiling to the maximum amount of total TEs that can be claimed. So over time, the ceiling could be abolished. However, as long as the tax system continues to have such a wide range of TEs, and therefore such a narrow tax base, the ceiling should be maintained while its scope should be enlarged to include all voluntary payments. Small adjustments could be made to the ceiling in the more immediate term to improve the fairness of the PIT regime, but the design of this ceiling in the long term will depend on the degree of base broadening.

The TIC supports existing measures for business expenses to only be deductible if they have been paid electronically and are verifiable with an invoice. These measures should prevent abuse of deductions by the self-employed, who can currently deduct all of their business expenses from their general income and thereby exceed the 40% ceiling. Strong monitoring and enforcement of these expenses is also recommended.

Colombia should calculate the tax revenue foregone of each TE on an item-by-item basis. However, these calculations can be complemented with a calculation of the tax revenue foregone if all taxpayers would use the TEs up to the maximum of 40% of general net income. Whether or not taxpayers claim tax deductions up to the 40% ceiling is an empirical question that DIAN can answer based on individual tax return data. This calculation would be a complement and would allow verifying the total amount of TEs that have been calculated on an item-by-item basis.

### **Taxation of pensions and other types of replacement income**

Colombia does not have a well-defined TE benchmark, including for the taxation of pensions. The TEs that DIAN currently calculates with respect to pensions provides an indication of the benchmark that Colombia implicitly applies. This implicit benchmark should, however, not be interpreted as guidance on how pensions should be taxed in Colombia. This discussion goes beyond the scope of this report.

On the one hand, Colombia seems to apply an “EET” benchmark for compulsory social security contributions, including pension contributions. On the other hand, it seems to apply a “TTE benchmark” for voluntary pension contributions that are exempt income, as DIAN reports these deductions as a TE. Moreover, private pension contributions to mandatory schemes that take the form of non-taxable income item are not measured as a TE due to a lack of disaggregated data.

The tax benchmark that is applied has an impact on the identification and measurement of TEs. While under an EET benchmark the deduction of mandatory social contributions is not a TE, the lack of taxation on the replacement income that is received, including the pension, is a TE. If Colombia chooses a TTE benchmark for voluntary pension savings, the upfront deduction of the contributions made from income tax is a TE, but the absence of income tax on the replacement income received, including the additional pension, is not a TE. In fact, the taxation of the private pension that is received would constitute a negative TE.

From a tax policy perspective, pensions are currently largely untaxed in Colombia and this is particularly unfair. As mandatory and voluntary (up to a ceiling) pension contributions are deductible at marginal PIT rates, and the pension itself is largely untaxed, the marginal effective tax rate on pension savings is negative. It means that government subsidises not only pay-as-you-go pensions as well as individual savings accounts, and this subsidy is increasing with income and the individual’s marginal tax rate at which contributions can be deducted (even if the contribution ceiling has been reached). The limited taxation of pensions favours richer pensioners the most and undermines the overall progressivity of the tax system. The taxation of pensions clearly needs reform.

### **Dividends, capital gains and other forms of capital income**

Different types of capital income are taxed differently. The lack of a well-defined TE benchmark complicates the identification and measurement of the capital income TEs. For instance, interest payments are taxed as part of general income at progressive PIT rates, with a top PIT rate of 39%. Dividends, however, are taxed first at the CIT rate of 32% in 2020, (31% in 2021 and 30% as from 2022 onwards) and then again at a withholding tax rate of 10% for dividends exceeding 300 UVTs while dividends below that amount are not taxed. This results in a combined statutory tax rate of 30% for dividends below UVT 300 and 37% for dividends above that ceiling. This raises the question of whether the difference in the tax burden between interest income and dividends is a TE or not. This question cannot be answered because no tax benchmark has been identified. In fact, the value of the TEs would differ depending on whether the dividend tax treatment or the interest tax treatment is chosen as the tax benchmark. If both income types are included in the benchmark, there would be no TE identified.

The realised capital gains on shares listed in the stock market are considered non-taxable income. The value of this TE will depend on the tax benchmark that is applied. Does the capital gains tax exemption

need to be compared with the tax burden on dividends or with the tax burden on interest payments? If the benchmark would consist of the tax treatment of dividends, would this then include both dividend withholding taxes; i.e. the CIT recapture tax if the realised capital gains do not correspond to profits that have been taxed at the CIT rate as well as the 10% withholding tax? Or is the benchmark the progressive PIT rate schedule that applies to interest income, but in this case, would the benchmark then take into account that capital gains might have been the result of profits that have paid CIT at the business level? And would the TE estimate then need to take into account that only the real return on interest income is taxed rather than the nominal return. Indeed, the measurement of the capital gains tax exemption is difficult without a well-defined tax benchmark.

### **Broadening the tax base would allow to lower rates and raise more revenues**

Colombia has a wide range of TEs that are generous and allow taxpayers to reduce their PIT liabilities significantly. The large difference in statutory and effective PIT rates are a result of the wide range of TEs that can be claimed. Put differently, effective PIT liabilities would increase significantly if PIT TEs would be narrowed, and this might have negative impacts on labour supply, entrepreneurship, innovation and savings. In addition to an analysis of TEs on an item-by-item basis, Colombia should therefore evaluate the impact of a PIT base broadening reform in terms of revenue, efficiency and equity across the income distribution.

Moreover, abolishing TEs and broadening tax bases might not necessarily result in more tax revenues if taxpayers can easily shift to other TEs. PIT base broadening may also induce self-employed workers to incorporate their business and claim CIT rather than PIT TEs, or to split up their business in multiple businesses in order to benefit from the RST regime, for instance.

A microsimulation performed by DIAN upon the OECD's request suggests that tax revenues would increase by almost 2 percentage points of GDP if the following PIT rate schedule would be implemented:

- 0% up to income equal to twice the minimum salary,
- 15% rate on taxable income between 2 and 3 minimum salaries,
- 25% rate to the remaining taxable income

In additional, all exemptions and tax allowances were abolished (except for the deduction of mandatory social security contributions).

The government should therefore evaluate whether a tax base broadening reform could go hand in hand with a reform that lowers the tax rates and equalises the tax treatment across different types of personal income. Indeed, while a discussion on TEs is a necessary first step, it is only a starting point for the discussion and preparation of a tax reform.

## **6.5 Conclusions and Reform Options**

The effective tax rates that individuals pay on their labour income, personal business income and capital income are very low. The low tax burdens are a result of various factors, including very generous tax deductions that increase with income, a wide range of tax exemptions, large brackets in the PIT rate schedule, a generous basic PIT allowance, a quasi-tax exemption for pension savings, and low rates on dividends and capital gains.

In addition, employers are allowed to make tax-free contributions for pension savings, health insurance and educational expenses for their employees. These exempt types of income are tax deductible for the employer and are not taxed as general income for the employee. This constitutes a large TE that benefits



employers and workers in good quality jobs the most. Such fringe benefits only further reduce the effective PIT rates levied on employees.

Another issue is that mandatory and voluntary pension contributions are deductible (up to a ceiling) at marginal PIT rates in addition to the pension itself being largely untaxed. Consequently, the marginal effective tax rate on pension savings is negative. This means that the government in fact subsidises private pension savings, and this subsidy increases with the individual's income and marginal tax rate. One approach could be for the government to limit the deduction from general taxation; or alternatively if mandatory and voluntary pension contributions remain tax deductible, pensions could be taxed jointly with labour income at progressive PIT rates. Colombia needs a fundamental reform of the taxation of pensions that limits the deduction of voluntary pension savings and/or start taxing the pension itself (below the current high exemption threshold) while avoiding that pension savings are taxed twice (i.e. once when the pension savings are made and then again when these savings are withdrawn in the form of a pension).

Colombia must reform the tax allowances within its PIT that increase with income. This form of tax design is egregiously regressive. First, these tax deductions increase with income, so richer households obtain a larger tax deduction. Second, the value of a tax allowance increases with the taxpayer's marginal tax rate, so the value is higher for richer households. And third, lower income households typically do not benefit from deductions such as mortgage interest relief or voluntary pension contributions as their income is too low to own a house or to save extra for a private pension. These tax allowances, some of which are explained below, are hence very uncommon in the OECD as they create a significantly larger tax advantage for richer households.

The 25% deduction of labour income from taxable personal income is unnecessary because the PIT rate schedule includes a generous 0 percent rate bracket within the PIT rate schedule, which aims at achieving a similar objective. The level of the basic tax allowance is also too high and should be reduced. Although optimally, the 25% deduction would be abolished, a more gradual reform that would reduce this percentage while the tax base is broadened may be more feasible. Another option could be to maintain the TE in the short run to help find political support to significantly broaden the PIT base.

Colombia has a maximum of TEs that can be claimed, equal to 40% of net taxable income and up to a maximum value of 5 040 UVTs. This TE ceiling serves as a base protection measures as the possibilities to reduce taxable income are large. The 40% of net taxable income ceiling is increasing with income and the value is increasing with the taxpayer's marginal PIT rate. The ceiling itself is therefore regressive (albeit mitigated somewhat by the maximum value of 5 040 UVTs). If the PIT base is broadened, as suggested by the TIC, the ceiling will become unnecessary and can be abolished. However, if the PIT base remains narrow, a TE ceiling could be maintained while ensuring that all voluntary contributions fall under its scope.

The self-employed can deduct all of their business expenses from their general income and by doing so exceed the 40 percent ceiling. In order to prevent abuse and to ensure that only business expenses are deducted, the government should maintain the existing requirement that only business expenses are deductible that have been paid electronically and for which an invoice has been received. Furthermore, tax enforcement should be reinforced for the self-employed. This would allow strengthening both income tax and VAT compliance.

The design of the taxes on personal capital income can be improved. The tax burden on capital income can be partly shifted from the corporate level towards the personal shareholder level. Conditional upon a broader capital reform, the tax exemption for listed shares could be abolished over a transitional period of up to five years.. Moreover, Colombia should continue to embrace and make use of the on-going automatic exchange of tax information with an increasing number of countries to ensure the fair taxation of capital income, irrespective of whether income is earned and assets are held in Colombia or offshore. There is also scope for reform to move towards using market-based valuation for the tax base with respect to property

and asset valuations. One way in which government can deter the undervaluation of property is to act on their right to purchase property at the undervalued price and communicate widely when it has done so to strengthen the credibility of this mechanism.

As part of this Commission, DIAN has made significant efforts to improve its tax revenue foregone estimation methodology. These efforts should continue so that the Colombian TE report can include tax revenue foregone estimates based on individual tax returns as well as provide estimates for each TE on an item-by-item basis. In addition, the TE report should include information on the distributional impact of the main TEs, which would increase transparency and help advance the tax policy discussions Colombia.

Although it is not discussed in this report, discussions with local tax experts have indicated that the tax residency requirements for individuals are not aligned with international practice and give rise to tax avoidance opportunities. The tax residency rules should be reviewed and, possibly, be reformed in accordance with international practice.

Finally, abolishing TEs and broadening tax bases might not necessarily result in more tax revenues if taxpayers can easily classify their income in ways that allow them to use other TEs. Therefore, the TIC recommends that the government introduce a tax base broadening reform that goes hand-in-hand with a reform that lowers tax rates when the time is right and equalises the tax treatment across different types of personal income. Simulations that were carried out for the report and are discussed in this chapter, show that a broad PIT base with a basic allowance that equals (once or twice) the minimum salary with three PIT rates would raise significantly more tax revenue than the current PIT rate schedule and would allow a reduction in the top PIT rate to 25%. As the Commission's analysis has shown, the breadth of TEs in Colombia's tax system reflect systemic structural issues. Thus, while an evaluation of TEs is a necessary first step, it is only a starting point for the discussion and preparation of a wider tax reform.

## Annex 1.D. Tax Expenditures Pertaining to Individuals, Employment and Dividends

### Standard tax allowances:

- Mandatory health and pension social security contributions made by employees or independent professionals (i.e. the self-employed);
- 25% of labour income is deductible; this deduction cannot be higher than 2 880 UVT per year;
- Tax deductions for the support of dependents; with a ceiling of 10% of general gross income and 384 UVT per year;
- The 40% ceiling of total exempt income and deductions that can be claimed, with an absolute value of 5 040 UVT, does not have to take into account the following items, or does not apply in the following circumstances (non-exhaustive list);
  - Social benefits received by the members of the Military or the National Policy while being in active duty or retirement;
  - Excess of basic salary received by officers, non-commissioned officers, and professional soldiers of the Military;
  - Excess of basic salary received by officers, non-commissioned officers, executive level personnel, patrolmen and agents of the National Police;
  - Representing expenses of headmasters and professors at public universities, which may not exceed 50% of their salary;
  - In the case of judges of the High Courts, their prosecutors and judicial attorneys, a percentage equivalent to 50% of their salary will be considered exempt representation expenses;
  - For judges, the exemption percentage will be 25% of the salary.

### Personal business income-related standard tax allowances:

- Self-employed individuals can deduct all costs and expenses incurred in their business (i.e. they are not limited to the 40% deduction ceiling).

### Non-standard tax allowances:

- Voluntary contributions to private pension funds made by the employee; the deduction cannot exceed 25% of general gross income and cannot exceed 2 500 UVT;
- Voluntary payments for additional health insurance paid to private health insurers that provide supplementary services to mandatory health insurance, to protect the worker, his partner, his children and dependents. The tax deduction cannot exceed 192 UVT per year.

### Savings related non-standard tax allowances include:

- Voluntary contributions to the individual savings scheme are not deemed as taxable income, in a percentage that does not exceed 25% of general income, limited to 2 500 UVT;
- Mortgage interest relief; the deduction is limited to 1 200 UVT per year;
- Costs and expenses incurred to earn “capital income” are tax deductible. They are not limited to the 40% deduction ceiling.

**Individuals that receive a pension can benefit from the following tax deductions:**

- Pension income below 12 000 UVT (about USD 116 000) is tax exempt (i.e. there is a tax allowance of 12 000 UVT);
- Mandatory health social security contributions paid by a pensioner are deductible.

**Tax allowances under the dividend income schedule:**

- Dividends paid to an individual shareholder that do not exceed 300 UVT (about USD 2 900) are tax deductible.

**Tax allowances under the occasional income category (i.e. capital gains):**

In addition, the realised capital gains on fixed assets owned for a minimum of two years or other occasional income may benefit from a tax deduction. The tax law specifically states that the following capital gains are exempt:

- Life insurance compensations are exempt, up to 12 500 UVT (about USD 120 000);
- Realised capital gains from the sale of homes, up to 7 500 UVT (about USD 72 000);

And also:

- The equivalent of the first 7 700 UVT (USD 74 000) of a rural property and the equivalent of the first 7 700 UVT in the inheritance, regardless of the number of heirs;
- The equivalent of the first 3 490 UVT (USD 34 000) of the value of the allowances that each of the heirs and the surviving spouse received;
- 20 percent of the value of the assets and rights received by individuals other than the heirs and / or the surviving spouse for inheritances and bequests, and 20% of the assets and rights received for donations and other acts, limited to 2 290 UVT (USD 22 000);
- The value of transferred property is based upon the historical cost and not the current market value of the property.

**Tax deductions under the Simple Regime RST**

- The RST in itself;
- Tax credit for employer pension SSCs;
- The VAT registration threshold (turnover below UVT 3 500).



# Working Party 5: Preferential Tax Treatment for Free Trade Zones in Colombia

Tax Expenditures Report



## 7. Working Party 5: Preferential Tax

### Treatment for Free Trade Zones in Colombia

*Valid arguments exist to maintain a “Free Trade Zone” (FTZ) regime in Colombia as long as the standard business tax regime remains uncompetitive. Despite recent efforts to improve the design of the business tax regime, the tax burden on businesses remains very high, which creates hurdles for both domestic and foreign investment. This lack of competitiveness has been mitigated through the introduction of FTZ regimes, which have contributed to growth, investment and employment. However, 75% of total investment in FTZs is domestic and relatively few foreign MNEs are using the regime. Moreover, the expansion of FTZs into almost all sectors and regions of Colombia has created tax challenges, in particular because the current FTZ design undermines the proper functioning of the VAT. These challenges are related to the fact that Colombia has given Free Trade Zone (FTZ) status to businesses that do not belong under such a regime as they mainly produce for and sell to the domestic market. Rather than deepening the tax incentives for FTZs, or creating other FTZ regimes, Colombia’s key priority should be to make the standard business tax regime more competitive so that the country no longer needs to mis-use the FTZ regime to provide preferential tax treatment to businesses that are serving the domestic economy. This type of reform would allow the FTZ regime to merge with the regular CIT regime over time.*

*Before 2020, FTZ businesses that sold goods to the domestic economy did not have to file an import return when these goods were imported. This design failure has been fixed recently. Nevertheless, the current VAT rules for FTZs continue to represent poor practice. They entail a too high risk of fraud, shift the burden of the VAT onto domestic businesses that sell to FTZ businesses, and increase the enforcement costs for DIAN. Because Colombia has extended the FTZ status to businesses that mainly serve the domestic market and because these businesses are not grouped in special economic zones but are found across the entire country, the FTZ businesses should be brought within the regular VAT regime. This is particularly true of new FTZ businesses, but if feasible should also be extended to existing FTZ businesses. If the government cannot change the VAT treatment of existing FTZs, it should not create any new Special Permanent FTZs in the future. VAT rules should apply for transactions from the domestic economy to a FTZ business (rather than being exempted) as well apply to imports of FTZ companies. This reform could be accompanied by the introduction of a system that allows FTZ businesses to defer the payment of VAT on imports from abroad, and a duty drawback provision under which import duties are refunded upon the exportation of qualified articles. In addition, the functioning of the VAT should be strengthened, in particular by providing a full credit for the input VAT on investment against output VAT in a timely manner.*

*The tax exemption for International Logistic Distribution Centres (CDLIs) is not aligned with the international trends towards a global minimum tax. Their CIT exemption can be abolished unless an in-depth analysis indicates that the social benefits exceed the associated social costs. Finally, it is important that FTZ businesses continue to report taxable income and any other information to DIAN in the same way businesses in the national economy have to. Data from DIAN shows that the tax revenue foregone of the reduced CIT rate for FTZs is very low. This means that either FTZ companies are not very profitable or that they use other TEs that reduce their taxable income.*

#### 7.1 Introduction

The Free Trade Zones regime in Colombia aims at stimulating investment and job creation. According Article 1 of Act 1004 of 2005:

*“The Free Trade Zone is the geographical area delimited within the national territory, where industrial activities of goods and services, or commercial activities, are carried out under special regulations in tax, customs and foreign trade matters. Goods entered in these areas are considered outside the national customs territory for import and export tax purposes”.*

Overall, the effect of the FTZ regime in promoting exports seems modest. Without the mining sector, exports from FTZs represent only 0.4% of total exports in Colombian, according to the information provided by DIAN.

The Ministry of Commerce is in charge of issuing administrative rulings granting or denying FTZ status. Companies resident in the country, branches of foreign companies, renowned technological parks, port companies and health care service companies can apply for FTZ status (IBFD, 2020).

Special labour regulations apply to the FTZs including: i) employees must have a formal (i.e. payroll and social security contributions are paid) and open-ended labour contract and ii) be hired in relation to the production or service process of the business located in the FTZ regime.

## 7.2 Types of Free Trade Zones

Colombia has three types of FTZs:

**Permanent Free Trade Zones (PFTZs)**, including:

- PFTZ that are zones that welcome several users, including industrial and commercial users;
- Off-Shore PFTZ for activities related to technical evaluation, exploration and production of offshore hydrocarbons and other related activities.

**Special Permanent Free Trade Zones (SFTZs)** that apply to single-company FTZs; depending on the economic activity of the business. In order to qualify, single-company FTZs must meet certain thresholds in terms of required investment and employment creation.

**Transitory Free Trade Zones (TFTZs)** are areas within the national territory where national or international fairs, exhibitions, congresses, and seminars are held, which are deemed important for the economy and/or international trade. These FTZs are exempt from VAT and custom duties. This exemption only applies to goods that are exhibited. If goods are sold in Colombia, VAT and custom duties apply. The benefits for TFTZs are more customs benefits than tax benefits. The objective of this instrument is to simplify customs procedures to attract investors and events to the country and generate new export opportunities for the participants in national or international fairs, exhibitions, congresses, and seminars.

Corporations need to comply with investment in fixed capital and employment requirements to obtain the permission to operate a FTZ. Investment and job creation requirements vary widely between PFTZs and SPFTZs as well as across sectors (see Tables A.1, A.2 and A.3 in the Annex). For example, an industrial or services company can be established in a PFTZ by creating just seven (7) direct jobs, but SFTZs are required to create a minimum of 150 direct jobs. In the case of SFTZs the greater the amount of the new investment, the lower the requirement in terms of jobs created. For service sector firms in SFTZs, job requirements are significantly higher if the investment is lower than USD 24 million (ranging from 350 to 500 depending on the amount of the investment). In the case of agro-industrial SFTZs the requirement is to either invest 75 000 SMMLV (approximately USD 18 million) or create 500 jobs (direct and indirect).<sup>37</sup> Overall, SPFTZs require higher amounts of new investment and numbers of jobs created. Notably, all of the promised

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<sup>37</sup> SMMLV: minimum monthly wage.

investment must be executed within the three-year period following the declaration of the existence of the SFTZ.

The following SFTZ regimes can be found in Colombia (non-exhaustive list):

- Special Permanent Free Trade Zone for goods;
- Special Permanent Free Trade Zone for services;
- Special Permanent Free Trade Zone for agro-industrial activities;
- Special Permanent Free Trade Zone for the dairy sector;
- Special Permanent Free Trade Zone for health services;
- Special Permanent Free Trade Zone for port services;

Overall, the FTZ regime in Colombia aims at allowing companies that operate within the FTZ to compete with companies in other Latin American countries that benefit from lower corporate taxation. The FTZs are seen by government as a tool for regional development and a vehicle to attract investment. For example, the rationale for allowing agro-businesses to operate in an FTZ is linked to encouraging the formalisation of the sector as well as improving its competitiveness. The agro-industry is a labour-intensive sector and the formalization of employment is complex. For this reason, establishing a SFTZ in the agro-industrial sector require an investment of almost USD 18 million or the creation of 500 jobs. The government considers that Colombia has the potential to further develop the agro-industrial sector and in this way catch up with its main competitors in the region.

## 7.3 Types of FTZ users

There are four different types of permanent and special FTZ users (IBFD, 2020):

- **Operators** - legal entities authorised to manage, direct, supervise, promote and develop one or more FTZs;<sup>38</sup>
- **Industrial manufacturers/users of goods** - legal entities authorised to produce, transform or assemble goods through the industrial processing of raw materials or unfinished products exclusively within FTZs;
- **Industrial users of services** are authorised to render all kinds of services including transportation, distribution, packaging, labelling, management, medical services, telecommunication services, scientific and technical research, tourism, repair, cleaning or quality testing of goods, technical support, maintenance and repair of equipment, ships, aircraft or machinery, audit, administration, brokerage and consulting. To operate in the FTZ companies need to create a new entity (for example, by creating a new trademark);
- **Commercial users** - legal entities authorised to carry out marketing or storage activities, or the preservation of goods in FTZs;

Industrial users of goods and industrial users of services must be new legal entities. They may carry out both activities simultaneously. These users do not have limitations for the provision of their services either with other users within the FTZ or with companies outside the FTZ, although the tax treatment differs in

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<sup>38</sup> The user operator may authorize the installation and operation of support companies within the area declared as an FTZ to develop activities such as surveillance services, maintenance, day-care, cafeterias, financial institutions, restaurants, training, basic medical care for employees, transportation of employees, and other services required to support the operation of the free zone. These companies do not benefit from the incentives of the users of the FTZs and are subject to controls regarding the handling of goods.



each case. Commercial users do not need to be new legal entities and they cannot carry out any other FTZ activity. However, they can carry out their activities within the FTZ and in the regular economy in Colombia as they are subject to the general tax regime.

In transitory FTZs there are two types of users:

- **Managing/administrator users** are the entities that must administer the area where a temporary FTZ is located. The user-administrator must be constituted as a legal entity, with legal capacity to organise national or international events, as well as to develop promotional, management and administrative activities of the area;
- **Exhibitor users** are the persons qualified as exhibitors in a national or international event carried out in a temporary FTZ.

## 7.4 Tax Incentives in the Free Trade Zones regime in Colombia

Businesses within the FTZ regime benefit from both indirect and direct tax incentives.

### Indirect tax incentives

- Businesses within the FTZ regimes are not subject to import and export duties and no VAT is levied on imports into the zone. However, goods that are brought into the national territory, will be subject to custom duties and VAT will be levied;
- When FTZ businesses buy goods from the national territory, these goods are VAT exempt; businesses are entitled to receive a refund for the input VAT paid on a bimonthly basis, under the condition that these goods are necessary for the business operations of the FTZ businesses.
- However, the VAT exemption does not apply to the introduction to a FTZ from the National Territory of the following goods for consumption or use within the FTZ:
  - Building materials;
  - Fuels;
  - Food, beverages and other items for consumption within the area.

### Direct tax incentives

- Reduced CIT rate levied at a rate of 20% for FTZs. That is, income earned in Colombia and abroad by an entity located in an FTZ will be subject to income tax in Colombia at a 20% rate.<sup>39</sup> Note that FTZ businesses fall under the Colombian double taxation tax treaties.
- However, commercial users are taxed at the standard CIT rate and do not benefit from the 20% reduced CIT rate. Commercial users are subject to the general tax regime (Article 240 of the Colombian Tax Code). There may be exceptions that can be examined on a case-by-case basis to determine if the commercial user benefits from additional tax incentives, but this is generally not the case.
- From the 2020 fiscal year, mega-investment projects can operate in FTZs. mega-investment projects located in FTZs are subject to the mega-investment income tax regime. Hence, the

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<sup>39</sup> Exceptions are (1) commercial users that pay the general rate (32% for 2020, 31% for 2021 and 30% as of 2022), (2) users with legal stability contracts apply the rate agreed in the arrangement and (3) users of new free zones, created between 2017 and 2019 in the municipality of Cúcuta (15% rate), provided that they (a) have more than 80 hectares and (b) guarantee that they will have more than 40 users between national and foreign companies (article 240-1 of the Tax Statute).

CIT rate that applies in this case is 27% but they do not have to pay the CIT recapture tax. The benefits of operating in a FTZ are related to VAT and custom duties incentives.

- Whether FTZs have to pay local taxes (e.g. the industry and commerce tax or the business property tax) or not depends on the specific regulations applicable in the municipality where the FTZ is located. That is, FTZs can also be benefited by territorial tax incentives.
- The dividend tax applies to FTZ businesses as follows:
  - The dividend tax rate applicable to distributions to non-resident shareholders: (i) a 10% dividend tax applies on dividends distributed from profits taxed at the corporate level, or (ii) a combined rate of 28% (20% plus an additional 10% dividend tax after applying the initial 20% rate) applies if dividends are distributed from profits not taxed at the corporate level;
  - The dividend tax rate applicable to distributions to Colombian companies: (i) a 7.5% dividend tax applies on dividends distributed from profits taxed at the corporate level or (ii) a combined rate of 26% (20% plus an additional 7.5% dividend tax after applying the initial 20% rate) applies if dividends are distributed from profits not taxed at the corporate level;
- Exemption from payroll fees (e.g., SENA: payment in relation to professional skills and training, ICBF: payment for family wellbeing), in accordance with the provisions of Article 114-1 of the Tax Statute. There is no exemption on social security contributions or non-tax compulsory payments (i.e. paid to a privately managed fund rather than to general government).

And also:

- Users located in an FTZ that have a legal stability contract have to pay the applicable income tax rate as stipulated in the contract (15%);
- Users of the FTZs in the city of Cucuta between January 2017 and December 2019 have a rate of 15%, provided that such free zones have more than 40 users and have an area of more than 80 hectares.
- The seven-year tax exemption that applies to the Orange economy (since 2019) also applies to businesses within the FTZ regime that qualify and meet the criteria set in the law.

### **Tax base protection measures**

In order to protect the domestic tax base, Colombia has implemented a number of base protection measures, including:

- Royalty payments are generally deductible with the exception of payments to related parties located in a FTZ that correspond to intangibles produced in Colombia;
- FTZ users that carry out transactions with related parties located in Colombia are subject to the transfer-pricing regime.

## **7.5 Forgone revenue**

### **Indirect tax revenue forgone**

Prior to 2020 FTZ businesses did not seem to collect all VAT from the goods sold to the domestic economy (and DIAN faced difficulties verifying the actual VAT due as FTZ businesses did not declare VAT collected on goods sold to the national territory). DIAN estimates show that the tax revenue foregone from the VAT exemption for FTZs was about COP 1 115 thousand million in 2017, COP 1 603 thousand million in 2018 and COP 1 858 thousand million in 2019. For 2018, this was slightly less than 1% of total tax revenues and 0.16% of GDP. The largest share (about 95%) of this tax revenue foregone is attributable to the foregone

VAT revenue on transactions from businesses located in Colombian customs territory (Territorio Aduanero Nacional) with FTZ users. The largest VAT revenue foregone is attributable to transactions from the following sectors (regarding transactions made to FTZ businesses):

- Mining and quarrying sector: 0.5% of total tax revenues in 2018
- Manufacturing industries: 0.2% of total tax revenues in 2018
- Wholesale and retail trade, repair of motor vehicles: 0.1% of total tax revenues in 2018

Ideally, the TE measurement should measure revenue forgone associated to the exemption rather than other factors that lead to a decrease in revenues such as tax evasion. The current VAT regime to the FTZ users was introduced by Act 2010 of 2019. Thereafter, FTZ users must declare VAT when selling goods to the national territory. As a consequence, DIAN revenue forgone estimates from the VAT exemption to FTZs users dropped significantly to COP 247 thousand million.

### Direct tax revenue forgone

Revenue forgone from reduced FTZ tax rates is estimated as the difference between the tax that would be paid under the general CIT regime in 2019 (33%) and the total tax to be paid. Revenue foregone as a result of the reduced statutory CIT rate equalled COP 580 thousand million, which is about 0.05 percent of GDP. SPFTZs operators accounted for the largest forgone revenue (see Table 7.1). DIAN is advised to include this estimate in the CIT tax expenditure section of the Marco Fiscal de Mediano Plazo report. In the 2020 report this estimate was only included in the total income tax revenue forgone (Table AP1.1 of the Appendix of the Annex to the MFMP), but the amount is not reported separately. Furthermore, this TE was not included in the table that lists different TEs in the Income Tax (section A.1 of the Appendix of the Annex to the MFMP).

**Table 7.1 Revenue forgone from reduced CIT rate, FY 2019**

Category	Number of Cases	Forgone revenue
Ind. Goods	32	55
Ind. Goods and Services	314	144
Ind. Services	173	18
Permanent Free Trade Zone	32	9
Special Permanent Free Trade Zone	56	354
<b>Grand total</b>	<b>607</b>	<b>580</b>

Source: FTZ - FTZU file, provided by the Ministry of Trade, Industry and Tourism -MINCIT in Spanish.

Note: This estimate does not include FTZs in Cucuta.

The low revenue forgone estimates from reduced rates indicate that FTZ companies use a wide range of other TEs to lower their taxable income to such an extent that the actual level of the tax rate does not matter much, as their tax base is very narrow in any case. This is particularly striking for special FTZs (see Table 7.2).

**Table 7.2 Income Tax Return data disaggregated by type of Free Trade Zone User, FY 2019, COP thousand million and number of companies**

Category	Number of Cases	Total Liquid Assets	Total Net Income	Total Costs and Deductible Expenses	Taxable Liquid Income	Net Income Tax	Total Tax to be Paid
Ind. Goods	32	1 199	3 392	3 025	370	61	61
Ind. Goods and Services	314	5 643	8 754	7 763	1 073	196	197
Ind. Services	173	595	1 059	919	137	25	25
<b>TOTAL FTZ USERS</b>	<b>519</b>	<b>7 437</b>	<b>13 205</b>	<b>11 707</b>	<b>1 580</b>	<b>282</b>	<b>282</b>
Permanent Free Trade Zone	32	1 182	280	262	70	13	13
Special Permanent Free Trade Zone	56	24 312	27 220	26 218	2 374	391	391
<b>TOTAL FTZ OPERATORS</b>	<b>88</b>	<b>25 494</b>	<b>27 499</b>	<b>26 480</b>	<b>2 444</b>	<b>403</b>	<b>403</b>
<b>TOTAL</b>	<b>607</b>	<b>32 931</b>	<b>40 704</b>	<b>38 187</b>	<b>4 023</b>	<b>685</b>	<b>686</b>

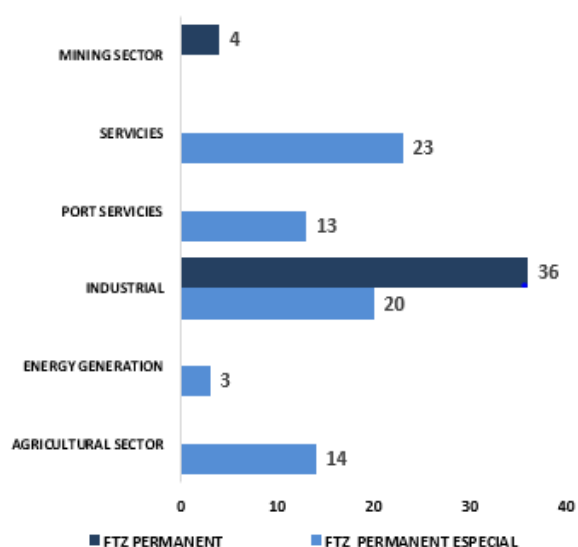
Source: FTZ - FTZU file, provided by the Ministry of Trade, Industry and Tourism -MINCIT in Spanish-. Aggregated data from Tax returns filed by Free Trade Zones and Free Trade Zone Users for 2019 (Form 110) provided by DIAN (SGAO DIAN).

Notes: No records of the application of the 15% rate for users of new FTZs in Cucuta were found (paragraph 4 of article 240-1).

## 7.6 Descriptive analysis of FTZs

In 2019, more than 750 firms operated within 113 Free Trade Zones, spread across the country. In total, there were 40 PFTZs and 73 SFTZs, distributed across sectors as presented in Figure 7.1. International comparisons indicate that Colombia has a large number of FTZs; in the LAC region, only the Dominican Republic has more FTZs.

Figure 7.1 Number of FTZs by type and sector, 2019



Source: ANDI (2019)

A number of indicators are available that can provide information about the economic contribution of FTZs. A selection of the available information on employment, investment, productivity, profitability and trade, has been summarised in the tables and text below.

**Table 7.2 Employment in Colombia's FTZ regimes, December 2018**

	Number of Firms	Direct Employment	Direct Employment per firm (average)	Indirect Employment	Indirect Employment per firm (average)
PFTZs	973	32 844	34	20 606	22
SFTZs	70	18 706	267	34 175	488

Source: ANDI (2019)

According to ANDI (2019), 51 550 people were directly employed in FTZs in December 2018. SFTZ-based firms provide 267 direct jobs per firm, on average. Collectively, firms operating within the SFTZs are thought to have exceeded their employment targets six-fold. On aggregate, it appears that firms in SFTZs create more employment than those in PFTZs, and that companies operating in FTZs do employ more staff than those in TANs. According to the Ministry of Finance, 86 people are employed in each company within FTZs, on average, as compared to 30 in TAN-based entities. However, the authors argue that there are various sectors in which FTZ users have fewer employees compared to companies of the same characterization located in the TAN (this is also true for certain categories of firm size).

**Table 7.3 Total Investment in Colombia's FTZs, COP thousand millions, December 2018**

	Number of Users	Domestic Investment	Foreign Investment	Total Investment	Investment per firm
PFTZ	973	6 617	1 866	8 483	9
SFTZ	70	29 628	12 698	42 326	605
Total FTZ	1 043	36 245	14 564	50 809	49

Source: ANDI (2019)

Unlike FTZs in many other countries, which are often more deliberately orientated towards attracting foreign direct investment (FDI), the vast majority of investment in Colombia's FTZs is domestic in origin. According to ANDI (2019), 78% of the investment in PFTZs and 70% of SFTZs was domestic, with the main source of FDI coming from Spain followed by Panama, the United States, Venezuela and Chile. Firms in PFTZs are said to have collectively exceeded their investment commitments by twelve times the qualifying threshold to be part of the FTZs, while those in SFTZs have surpassed theirs three-fold.

**Table 7.4 Trade balance in Colombia's FTZ regimes**

	Value (USD, millions)	
	2018	2019
PFTZ	281	405
SFTZ	789	1 267
Total FTZ	1 070	1 672

Source: DANE

Exports in FTZs amounted to approximately 7.6% of Colombia's total exports in 2019, up from just over 6.7% in 2018. SFTZs accounted for 65% of these exports. The trade surplus generated by FTZs (and in

particular SFTZs) has helped to limit the size of Colombia's overall trade deficit, although it has been mainly the mining sector that has contributed to narrowing the deficit.

FTZs do not seem to have had a notable impact in raising productivity. Analysis by the Ministry of Finance using the Rasmussen-Hirschman indexes suggests that there are relatively few companies operating in FTZs that have strong backwards and/or forwards linkages that would stimulate significant economic activity in other sectors.

An analysis by the Ministry of Finance indicates that companies located in FTZs have a significantly greater chance of surviving their first years in business than both TAN-based companies (1/3<sup>rd</sup> more likely) and the average Colombian company (three times more likely). Data from the Colombian Single Business Register (RUES) suggests that of the total number of companies registered in 2013 and 2014 in FTZs, more than 90% were still active after 5 years of registration. This compares to 68% observed for exporting companies and 35% for the national average.

Their higher chances of survival does not necessarily translate into stronger financial performance, however. An analysis by the Ministry of Finance highlights that FTZ-based firms have larger average asset valuations than their TAN counterparts, particularly for microenterprises, but that both large-sized enterprises and microenterprises earn lower gross margins on average than similar sized exporting companies. Small-sized companies appear to be an exception, with those located in FTZs reporting gross profits equal to 40% of revenue, double and quadruple the FTZ and national averages, respectively.

Evaluating the true economic contribution of FTZ regimes is challenging. A thorough assessment requires an examination of the FTZs' performance against a "counterfactual", i.e. what would levels of employment, investment, tax revenue and trade have been in the absence of the FTZs? The impact would then be estimated by comparing this "counterfactual outcome" to the economic outcomes that have been observed under the FTZs such that one can attribute a cause and effect from the existence of the FTZ regime. However, there are no studies to-date that have developed a counterfactual in order to accurately assess the economic impact of FTZs in Colombia, i.e. what additional investment, employment, exports has occurred exclusively as a result of the FTZs' incentives that would not have taken place otherwise.

## 7.7 International Logistic Distribution Centres

International distribution centres are public warehouses located in ports, airports or special logistic areas where foreign and national merchandise subject to distribution can be stored. Between 2015 and 2019, 15 international diagnostic distribution centres (CDLI) were established in Colombia. These 15 CDLIs are located within six departments – Atlántico, Bogotá D.C., Bolívar, Magdalena, Santander, Sucre – in either coastal areas or cities that transport most goods by air. Most are located in port terminals, with three quarters of the CDLIs in four of Colombia's eleven coastal departments.

There are a number of requirements that entities must fulfil in order to qualify to encompass a CDLI as well as a restricted number of operations that they can carry out (see Annex). Executable operations include the storage of foreign goods, national or in free disposal, or in process of completion of a temporary import or transformation and/or assembly, which will be distributed through one of the following ways: re-landing; import; export. Goods may also be subject to a limited number of operations, including: i) preservation; ii) manipulation; iii) packaging; iv) repackaging; v) classification; vi) cleaning; vii) laboratory analysis; viii) surveillance; ix) labelling; x) dialling; xi) placement of trade information legends; xii) separation of lumps; xiii) preparation for the distribution and improvement or conditioning of the presentation.

## 7.8 Tax Incentives in CDLIs

Under certain circumstances proceeds from the sale of goods of foreign origin, introduced into CDLIs owned by non-resident companies and located in airports, sea and fluvial ports in certain departments are not considered to be income earned in the country, as long as some specific requirements are met (article 25 of the Tax Code).<sup>40</sup> As foreign companies are taxed only on the income generated in Colombia this incentive implies foreign companies operating these centres are CIT exempt. This CIT exemption for non-resident companies is a tax expenditure and should be reported in the MFMP and the economic impact generated by these centres assessed.

DIAN considers two possible situations:

- The foreign company sells the goods stored in an international distribution centre to Colombian residents, and the import is made by the purchaser (Colombian resident). In this case, the foreign company is not subject to income tax on the sale of the goods and the foreign company is not obliged to set up a PE in Colombia. If foreign companies or persons without residence in Colombia, which own such goods, have some form of economic linkage to Colombia, their economic partners or related parties in Colombia may not obtain any benefit associated with the disposal of the goods (for the exemption to apply).
- The foreign company sells the goods to Colombian residents, and the import is made by the same foreign company. In this case, the foreign company is obliged to set up a PE in Colombia and is subject to income tax.

Furthermore, goods in CDLIs may remain for a term of one year without having the obligation to be imported. There is therefore no obligation for foreign companies or non-residents to settle and pay tariffs and VAT on imports, nor to meet the administrative requirements necessary to be able to import these products while the goods are stored. This one year term is automatically extendable up to an equal term.

## 7.9 Categorisation of the tax incentives that apply to the Free Trade Zones regime

The most important tax expenditures and tax incentives in relation to the Free Trade Zones are assigned into four TE reform categories:

- Category I: no reform is recommended/needed;
- Category II: TE base-broadening reform is desirable;
- Category III: reform might be possible over time, conditional upon the implementation of accompanying tax reforms;
- Category IV: whether or not to reform the TE requires further analysis, but the tax revenue foregone of the TE should be measured and the TE should be assessed.

In addition, the table below includes a fifth column that signals whether there is genuine doubt about whether a specific tax provision is actually a TE or not.

This tentative categorisation takes into account the following dimensions:

- The tax revenue foregone;

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<sup>40</sup> Article 25(c) of the Tax Code. To benefit from this incentive foreign companies must be *located in the departments of Guainía, Vaupés, Putumayo or Amazonas*.

- The economic impact of the FTZ regime, including the additionality of the attracted investment within the FTZ regime, whether the regime attracts foreign or domestic investors, distortions created by the regime, etc.;
- The tax planning and avoidance opportunities created by the tax incentives;
- The distributional effects and the possible windfall gains for investors;

The impact on the complexity of the tax system, the extent to which the TE creates challenges with respect to its administration, compliance and enforcement.

	Category I: No reform	Category II: Reform is desirable	Category III: Reform is conditional	Category IV: Unclear whether to reform or not	TE or not TE: that's the question
FTZ regimes	<ul style="list-style-type: none"> <li>• Reduced CIT rate</li> <li>• Local business tax exemption</li> <li>• Tax treatment of distributed dividends</li> </ul>	<ul style="list-style-type: none"> <li>• Business property tax exemption</li> <li>• Transitory FTZs</li> <li>• Indirect tax treatment</li> </ul>			
CDLI			<ul style="list-style-type: none"> <li>• CIT exemption for CDLIs</li> </ul>		

### Category I:

- **The reduced CIT rate of 20%:** this rate is aligned with the statutory business tax rates that can be found in the OECD on average (average CIT rate of about 25%);
- **Local business tax exemption:** this tax is levied on business turnover and, as discussed in the WP2 note, is very distortive as it is not levied on profits but on turnover. The tax can result in a very high effective tax rate for businesses that are not very profitable but have high turnover. The WP2 note recommended to abolish this tax; in the meanwhile, there are good arguments for municipalities that exempt FTZ businesses from the tax to continue doing so in order not to discourage investment in the FTZ regime;
- **Tax treatment of distributed dividends:** The tax treatment of distributed dividends is aligned with the general tax treatment. The CIT recapture tax is levied at the CIT rate that applies to the FTZ business (20% in the general case) in case dividends are distributed out of profits that have not been taxed under the CIT. Afterwards, a 7.5% or 10% dividend withholding tax applies. For an in-depth discussion of this tax treatment, and possible recommendations for reform, see the WP2 tax policy note. If a reform is considered, it should apply to all businesses, and not only FTZ businesses. This tax provision is therefore included in category I.

### Category II:

- **Business property tax exemption:** Recurrent taxes on immovable property, levied on individuals or businesses, can be found in all OECD countries; often, these countries finance local governments and pay for the local services that the property owner receives. Irrespective of whether businesses are located within or outside a FTZ, they benefit from the services they receive and, as a result, there are strong arguments to ask businesses to pay a local business property tax. The current exemption for FTZ businesses could therefore be removed by the municipality. This is particularly important for the financing of local communities in the event that the business turnover tax is abolished as this report recommends.



- **Transitory FTZs:** the tax policy rationale for transitory FTZs seems weak, as they do not result in a permanent increase in investment and employment. The benefits granted to TFTZs are more customs benefits than tax benefits. Special customs rules should be designed rather than a FTZ regime as the objective of these benefits is to simplify customs procedures.
- **Indirect tax treatment exemption:** The TIC recommends bringing FTZ businesses under the standard VAT regime as it applies to domestic businesses, under the condition that the design of the VAT in Colombia is improved, including a refund for the input VAT paid on investment. In Colombia, FTZ businesses currently do not pay import duties and VAT on imports from abroad. Goods purchased by FTZ businesses from the domestic economy are exempt in order to avoid a competitive disadvantage for domestic businesses compared to imports. The TIC recommends that the VAT should apply to imports made by FTZ businesses from abroad as well as on purchases made from the domestic economy. Including FTZs within the regular VAT would facilitate the integration of both business tax regimes over time.

FTZs can be found across the world. FTZs are generally duty-free extra-territorial zones that facilitate the processing of imported goods before they are exported. As FTZs are extra-territorial, no custom duties and VAT is charged, following guidance in the revised Kyoto Convention. Any goods that are sold from the FTZ to the regular economy are treated as regular imports, and charged with custom duties and VAT. The indirect tax design of FTZs is very much linked to the export focus of FTZs, which tend to be located in designated areas such as harbours in order to facilitate the export process. While the revised Kyoto Convention provides guidelines on how to design a Free Trade Zone, the Convention does not introduce binding rules on how the VAT should be levied.

FTZs in Colombia deviate from the general approach that FTZs are located in designated areas from where businesses can export, in particular because FTZs can be located across the entire Colombian territory. The Colombian FTZs have a less strong export focus but strongly aim at serving the domestic economy. The regime is an attempt to compensate for the lack of competitiveness of the domestic business tax regime. However, the current approach leads to a wide range of fraud opportunities, it shifts the burden of the VAT from FTZ businesses to domestic businesses that sell to FTZ companies and it increases enforcement costs for DIAN. It undermines the functioning of the VAT and these risks increase with the number of single-company FTZs in Colombia.

If COL wants to apply a preferential VAT regime for certain imports, it should be a regime whereby the payment of import VAT is deferred from the border to the importing business's VAT return (subject to authorisation in light of the importing business's risk profile). This essentially means that all the normal checks and formalities at importation are carried out but that the importer can pay the import VAT in its VAT return and deduct it under normal VAT deduction rules in the same return. That leaves the VAT compliance (and reporting) process in place while limiting the cash flow impact for the importing business. The current VAT exemption for sales from the regular economy to FTZ businesses can be abolished.

This approach could be complemented with duty drawback provisions under which import duties paid on imported goods are refunded upon the exportation of qualified articles. Essentially, duty drawback is an export promotion program intended to eliminate or recover the costs of duties on merchandise sold on international markets. It is one of the few export incentive programs acceptable under WTO rules. Duty drawback programs can be found around the world. They can be designed in different ways, such that they are favourable for businesses that import, process and export goods.

In that respect, the TIC holds the view that if Colombia is bound by the extra-territoriality of the FTZ regime and cannot levy VAT under standard rules, then the FTZ regime that single

businesses benefit from should be abolished as that regime undermines the functioning of the VAT. If government cannot change the VAT treatment of existing Special Permanent FTZs, it definitely should not create any new SFTZs and let the regime phase out.

### Category III:

- **International Logistic Distribution Centres:** There are good reasons to reform this TE as part of a broader CIT reform. The tax exemption is not aligned with the international trends towards a global minimum tax and, over time, might imply that Colombia will be giving away tax revenues to the jurisdictions where the CDLIs parent company are tax resident. Arguments for foregoing taxing these profits from foreign companies are therefore weak. Instead, CDLIs should be taxed under CIT rules. Nevertheless, before removing, Colombia may want to carry out an in-depth cost benefit analysis of this preferential tax treatment.

## 7.10 Conclusions and options for reform

Despite recent efforts to improve the design of the business tax regime in Colombia, the tax burden on businesses remains high and the regular tax system is not particularly competitive, discouraging both domestic and foreign direct investment. The Colombian Free Trade Zones therefore appear to have been introduced to partially compensate for the lack of competitiveness of the regular business tax regime. The FTZs provide profit-based incentives in the form of lower corporate income tax rates – 20% as compared to 32% (2020) in the regular CIT schedule<sup>41</sup> – and in some municipalities through excluding FTZ businesses from non-profit based taxes such as the local business turnover tax as well as business property taxes.

Colombia's FTZ regimes have multiple policy objectives. These range from improving competitiveness and productivity, increasing investment and employment, boosting export diversification and the trade balance, and even operate as tools for regional development. Data from a study undertaken by the organisation for users of the FTZs (ANDI, 2019) reveals that 75% of total investment in FTZs is domestic and that relatively few foreign MNEs are using the regime. Overall, the FTZ regime has not been overly successful in stimulating exports, in particular if the mining sector is disregarded. Furthermore, a lot of the investment that takes place in FTZs is oriented towards sales in the domestic market. However, the regime has been successful in attracting businesses that exceed the set targets in terms of investment and employment, but whether this implies that all of this investment and all of these jobs are truly "additional" has not yet been assessed in an empirically convincing manner. Whether or not the benefits of the FTZ regime outweigh the costs is therefore, to some extent, irrelevant in the Colombian context, as the standard tax regime is too distortive (there is an extensive literature that explains that high tax rates on investment reduce growth).

Strong arguments therefore exist to maintain a "Free Trade Zone" regime in Colombia as long as the standard business tax regime remains uncompetitive relative to peers. However, Colombia does not need more FTZs. Rather than further deepening the tax incentives that apply to FTZ businesses, the first priority for Colombia should be to make the standard business tax regime more competitive so that the country no longer needs to (mis-)use the FTZ regime to provide preferential tax treatment to businesses that are mainly serving the domestic market. Such a reform would allow the FTZ regime to merge with the regular CIT regime.

The current VAT rules for FTZs represents poor practice. They entail a too high risk of fraud, shift the burden of the VAT onto domestic businesses that sell to FTZ businesses, and increase the enforcement costs for DIAN. Because Colombia has extended the FTZ status to businesses that mainly serve the domestic market

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<sup>41</sup> The 32% rate is applicable for 2020. The CIT will be reduced to 31% in 2021, and to 30% as of 2022.

and because these businesses are not grouped in special economic zones, but are found across the entire country, the FTZ businesses should be brought within the regular VAT regime. This is particularly important for new FTZ businesses, but if feasible should also apply to existing FTZ businesses. This implies that VAT rules should apply for transactions from the domestic economy to a FTZ business (rather than being exempted) as well apply to the imports (from abroad) of FTZ companies. This reform could be accompanied by the introduction of a system that allows FTZ businesses to defer the payment of VAT on imports, and a duty drawback provision under which import duties paid on imported goods are refunded upon the exportation of qualified articles. However, if government cannot change the VAT treatment of existing FTZs, it definitely should not create any new Special Permanent FTZs in the future. In addition, Colombia needs to strengthen the functioning of the VAT, in particular through providing a full credit for the input VAT on investment against output VAT in a timely manner.

The rationale for the Transitory Free Trade Zone regime seems weak. Special customs rules should be designed rather than having a specific FTZ regime as the objective of these benefits is to simplify customs procedures. The CIT exemption for International logistic distribution centres (CDLIs) is distortive and can be abolished if a cost-benefit analysis would indicate that the social costs outweigh the benefits.

FTZ businesses now have to report taxable income and any other information to DIAN in the same way as businesses in the national economy. This represents good practice. Data from DIAN shows that the actual tax revenue foregone of the reduced CIT rate for FTZs is very low. This means that either FTZ companies are not very profitable or that they use other TEs and tax incentives that reduce their taxable income to such an extent that the tax revenue foregone of the reduced CIT rate is very small.

The large number of FTZs in Colombia – 113, second only the Dominican Republic in the LAC region – makes the tax administration of these regimes very challenging and creates transfer pricing issues within the country. This in turn increases tax enforcement costs for the administration and creates Base Erosion and Profit Shifting risks. According to DIAN officials, 4 173 taxpayers were covered by the transfer prices regime in 2018, reporting transactions worth COP 221 000 thousand million (approximately USD 63 thousand million).<sup>42</sup> This significant amount highlights the need to focus on monitoring these transactions more closely as the tax revenue at stake here is large.

Finally, any revision of FTZs and CDLIs must be made in light of tax reforms undertaken by other countries, particularly those related to international agreements on minimum taxes. A minimum global tax is likely to be adopted as part of the OECD solution to address the tax challenges arising from digitalisation (Pillar 2 of the OECD/G20 Inclusive Framework Project on the Tax Challenges arising from Digitalisation) in 2021 and Colombia should ensure that its FTZ taxation regime is aligned with these trends.

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<sup>42</sup> Comité Tributario y de Comercio Exterior, October 2020, presentation by DIAN officials.

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## Annex 1.E.

**Table A.1 Requirements for establishing industrial or service company in a Permanent Free Trade Zone**

Total Assets (USD)	Investment Amount (USD)	Minimum Direct Jobs Creation
0 – 130 467	0	7
130 467 – 1 302 070	260 414	20
1 302 330 – 7 812 420	1 302 070	30
+7 812 680	2 994 761	50

Notes: This information is presented in dollars using a USD 1 = COP 3.500 exchange rate. For 2020, the Minimum Monthly Legal Wage (M.M.L.W) was COP 877 802. The M.M.L.W, as well as the exchange rate, are subject to variations.

**Table A.2 Requirements for establishing a company in a Special Free Trade Zone – Services**

Investment Amount (USD)	Minimum Direct Jobs Creation
2 604 140 – 11 979 044	500
11 979 044 – 23 958 088	350
More than 23 958 088	150

Notes: This information is presented in dollars using a USD 1 = COP 3.500 exchange rate. For 2020, the Minimum Monthly Legal Wage (M.M.L.W) was COP 877 802. The M.M.L.W, as well as the exchange rate, are subject to variations.

**Table A.3 Requirements for establishing a company in a Special Free Trade Zone – Goods**

Investment Amount (USD)	Minimum Direct Jobs Creation
39 062 100	150

Notes: For every USD 5 989 522 of new additional investment USD 39 062 100, the employment requirement may be reduced by a number of 15, without in any case the total number of jobs being less than 50.



# Annex

Tax Expenditures Report



## Annex

**Bogotá D.C., March 2021**  
**Sirs,**  
**Members of the Tax Incentives Commission**

Subject: Comments of the Ministry of Agriculture and Rural Development on the recommendations and discussions in the Working Group No. 1 of the Tax Incentives Commission

Dear Members,

Taking into account that the Ministry of Agriculture and Rural Development did not integrate the Working Group No. 1 where the tax expenditures related to VAT were discussed, the Ministry of Agriculture and Rural Development would like to make some comments to express our point of view and concern about how the agricultural sector would be affected if the suggestions made by the Tax Incentives Commission were followed to the letter.

As indicated in the Final Report presented by the Tax Incentives Commission, it is clear that, by design, the VAT is supposed to be a broad-based tax that taxes the final consumption of goods and services, and that is why it is collected staggered on the added value of goods or services at each stage of the production and distribution chain. Likewise, its design allows the deduction of the tax paid VAT on purchases made in all stages of the supply chain but the one made by final consumer.

While there is a wide variety of tax incentives in Colombia, which must be reduced to those strictly necessary, it is true that there are certain sectors that, due to their determining conditions, it is required to have special treatments or tax incentives in VAT, in order to prevent affectation of the development of the particular sector.

The current structure of existing special treatments and tax incentives in the tax system targeted to the agricultural sector are quite correct and adequate with the situation and disposition of the sector. In this regard, the Ministry of Agriculture and Rural Development considers it important to remember that about 12 million people live in the Colombian countryside, of which approximately 47.5% live below the poverty line. The main and most challenging problematic in the agricultural sector is the generalized informality, whose index exceeds 91% and is reflected in the poor access to formal work, education, health, public services and financial services and in important deficiencies in road infrastructure and connectivity, which makes commercialization activities more difficult.

The agricultural sector is strategic in the domestic economy, contributing with 7.49% of the added value of the economy, and its formalization and incentive to enter the formal economy should be a priority for the Government, which should be reflected in tax reforms presented for discussion and approval in the Congress.

Because of the special relevance in the domestic economy of agricultural sector it is important that the implementation of new regulations avoid generating an increase in the production costs of the sector, in order to achieve greater competitiveness both at the domestic and international level of small producers (farmers, fish farmers and fishermen) and thus strengthen the contract farming policy.

As a result, there are specific VAT treatments for the agricultural sector that should be preserved not only to promote the formalization of the agricultural sector in the tax and financial side, but to allow ease in tax compliance by formalizing small farmers. Otherwise, if the tax compliance of VAT and Income Tax generates additional complications that are difficult to solve, small farmers will not see any benefit in formalization.

Additionally, VAT on any product in the agricultural production chain could considerably increase production costs, which, added to the existing informality in tax matters, could generate very serious adverse effects in investment and development of the agricultural sector.

It is important to remember that small farmers not only work from informality in all aspects, but they do not have the necessary knowledge and much less the support from institutions to have adequate understanding in the fulfillment of both formal and substantial tax obligations. In such a context, the reforms suggested by the Tax Incentives Commission could generate panic in farmers, who will prefer to remain informal, instead of being encouraged to enter the formal economy and comply with their tax obligations, as established by tax regulations.

Taxing inputs and machinery and equipment necessary for food production could negatively impact production costs in the agricultural sector, causing an adverse effect on the demand for food, as well as consequences on the employment generated by the agricultural sector.

On the contrary, as recommended by the Tax Incentive Commission, the tax system should be simplified, especially in respect of the fulfillment of formal and substantial obligations by small farmers to facilitate and encourage their formalization and access to the tax system. Additionally, the VAT compensation mechanism for the agricultural sector should be improved, as well as the optimization of the procedure and periods for the refund. With that being said, only when such formalization is achieved, accompanied by an assertive pedagogy and simplicity and efficiency not only of the VAT compensation but in the procedure of requests for the refund of VAT paid in the supply chain by agricultural producers, especially small ones, government can even think in taxing the sector throughout the supply chain.

Therefore, we present our comments below on each tax expenditure analyzed by the Tax Incentives Commission.

### **VAT exclusions**

Tax Incentives Commission recommends the conditional reform of agricultural and horticultural products, support services for the agricultural sector, fertilizers and insecticides and machinery for agricultural use. The reform is conditional on the full implementation of the VAT compensation mechanism.

In this regard, the Ministry of Agriculture and Rural Development, considers that it should also be conditioned to the deepening of the formalization of the sector and the simplicity and efficiency in the refund mechanisms, especially the VAT paid by small producers. Although it is true that the VAT compensation mechanism is an important tool that can solve many of the problems existing in the domestic economy, it is not the appropriate tool to address in the agricultural sector.

The VAT compensation mechanism is a direct compensation for final consumers, but it does not solve the problem of small producers and farmers in the sector who, due to informality and other reasons, cannot deduct the VAT paid in the acquisition of necessary inputs in the production chain of an agricultural product.

VAT on agricultural inputs, machinery and support services for the agricultural sector generates an increase in production costs and, therefore, in final products. This implies that the sector will become even more less competitive.



Thus, the Ministry of Agriculture and Rural Development does not agree with the recommendation included in the Final Report of the Tax Incentives Commission for the aforementioned goods and services that directly impact the agricultural sector. On the contrary, we consider that inputs such as seeds for planting, electricity, nutrients of animal or vegetable origin, insecticides, disinfectants, fertilizers and similar products, agricultural machinery and equipment and their parts and all the services of support to the agricultural sector for the adaptation and preparation of land, irrigation systems, drainage, application of fertilizers and agricultural products, sowing and harvesting, among others, must continue with the VAT exclusion that currently exists.

### **Reduced VAT rate**

Tax Incentives Commission recommends a reform towards the taxation with standard VAT rate of 19% of agricultural machinery and equipment and storage of agricultural products, as well as the preparations used for animal feed, conditioned to the implementation and full operation of the VAT compensation mechanism.

As mentioned before, if the acquisition of agricultural inputs and machinery and equipment is taxed with the standard VAT rate of 19%, instead of the reduced rate, the cost of production of agricultural products would increase, which would imply both the loss of competitiveness of the sector and the increase in the final prices of the products offered to the final consumer.

Once again, the VAT compensation mechanism is a tool that solves the problem from the perspective of the final consumer, however, small producers are directly affected by the increases that this generates in production costs and by the complexity of the tax system and compliance regarding tax obligations.

The inputs and agricultural machinery that currently have a reduced VAT rate should not be reformed to increase its rate to the standard VAT rate but should be included in the category of VAT excluded. All of the above, keeping in mind that plant materials and waste, preparations for animal feed, machinery such as rakes, axes and similar tools, dryers for agricultural products, fumigators, heat exchangers or pasteurizers, machinery for the preparation and work of the soil and the cultivation, the milking machinery and poultry farming machines and coffee pulping machines, among others, fulfill the same purposes as the inputs and machinery included in the category of VAT excluded.

For the Ministry of Agriculture and Rural Development it is crucial that the limited and special conditions of the agricultural sector population and the generalized informality that characterizes the sector are taken in consideration not only in the Final Report of the Tax Incentives Commission, but also in the drafting of future tax reforms.

In this sense, it is imperative that the proposed reforms take into account that the agricultural sector is currently not very competitive and is not attractive for investment, which is why a considerable increase in production costs could deteriorate the situation of the agricultural sector.

On the other hand, the incentive to formalize the agricultural sector, which is a priority of the Government, could be undermined by the increase in production costs and the complexity of compliance of tax obligations and paying taxes.

Finally, the Ministry of Agriculture and Rural Development considers that the agricultural sector is a very important sector for the domestic economy and is very sensitive to any change or reform of the rules that currently apply in tax matters, since any impact on the sector and the small farmers generates large economic implications.

Furthermore, the Ministry of Agriculture and Rural Development agrees with the development of the Tax Incentives Commission, the analysis carried out and the recommendations and suggestions included in the Final Report.

Yours faithfully,

A handwritten signature in black ink, appearing to read 'Jorge Caceres Duarte', with a stylized flourish at the end.

JORGE HERNANDO CACERES DUARTE

Head Office of Planning MADR

Elaborated: Andrea Ramirez Wolf - Office of Planning MADR

Bogotá D.C.,

To

**ALBERTO CARRASQUILLA**

Minister

Ministry of Finance and Public Credit

Subject: Position of the Ministry of Commerce, Industry and Tourism on the Recommendations by the Tax Incentives Commission.

Dear Minister,

I first want to thank you for your invitation to be part of the Tax Incentives Commission of Experts, where we have had the opportunity to review the tax regime in Colombia in view of the international best practices. The recommendations product of the rigorous labor of this Commission, constitute information of key importance for a debate regarding the tax reform.

On behalf of the Ministry of Commerce, Industry and Tourism, we have actively participated in the work group that assessed the tax benefits inherent to Free Trade Zones, instrument that has given the country the opportunity to attract and materialize large investments, generating an effect on job creation and production chains, as well as diversifying and promoting the economy in several regions, which are all public policy objectives of this Ministry.

In terms of the report, we fully agree on the conclusion that the Free Trade Zones figure has provided an opportunity to offset the lack of competitiveness in the Colombian tax regime in terms of attracting strategic projects and investments. Despite the efforts made by the Government towards reducing the tax burden on businesses, the report acknowledges that it is still very high, which creates an obstacle that prevents attracting domestic and foreign investment.

Due to the foregoing and acknowledging reality and the difficulties in competing with other investment destinations with more aggressive instruments, we have strengthened our investment attraction strategy. This strategy is comprised of four fundamental areas, in which the set of cross-cutting, sectoral, and regional tax instruments are essential in order to attract the attention of potential investors and materialize investments. The 4 areas that make up the efficient investment attraction strategy are presented below:

1. Investment Facilitation Tools. Includes a set of institutional instruments that provide assistance, dynamism and support to established investments and those considering the country as a potential destination for future investments. In this area, we work on the Red Carpet strategy and the Investment Facilitation Committee in order to provide support and timely response to the barriers and bottlenecks that investors face. Furthermore, we have worked in the design and implementation of two instruments since last year, which are categorized as international good practices in terms of investment retention and facilitation: The One-Stop Window for Investment and the Investment Ombudsperson, which surely will strengthen the efforts we have undertaken.

2. Tax and Non-Tax Instruments and Incentives to create investment opportunities in the country. These measures attempt to increase the attractiveness of Colombia as an investment destination by improving its business climate by means of tax incentives, facilitating access to different commercialization channels and regimes, as well as facilitating access to production factors for the productive development for the internal and external market of investors, among other factors. This area includes regimes such as Mega Investments, the programs of Plan Vallejo de Servicios and Plan Vallejo Express, the various measures in place to strengthen e-commerce and, of course, the Free Trade Zones regime.

3. Regional and Sectoral Actions. The third area is comprised of the set of measures aimed towards boosting strategic sectors and regions. These measures include special tourism projects, incentives for the

creative industries sector, renewable energies, agroindustry as part of sectoral incentives and the ZESes and ZOMACs as part of the regional incentives, in addition to the efforts made by the regions to generate additional incentives such as preferential rates or exemptions applicable to the ICA, among others.

4. Relocation or “Nearshoring”. The last work area refers to the accelerated trend in the current situation caused by the COVID-19 pandemic. The combination of clashes between commercial policies and the current crisis has generated uncertainty in terms of the future of commerce and the structure of global value chains, which are prioritizing resilience, risk diversification and customer proximity over efficiency. This generates special opportunities for countries such as Colombia, in terms of increasing its share in global chains, becoming a destination that can provide the best nearshoring alternative for companies. Even though this is a very specific work area that requires an investment attraction and specific segmentation approach to this type of investments, the same needs to be supplemented by the rest of these work areas to be materialized. This is particularly true for the tax and non-tax measures and incentives, in which the Free Trade Zones regime plays a key role in what the country can offer to competitively attract investments.

The Free Trade Zones regime has been the most effective instrument employed to offset the lack of competitiveness of the tax system in terms of attracting investments<sup>43</sup>; by means of the socioeconomic impact displayed in the Expert Commission’s Report in terms of more dynamic job creation when compared with businesses outside of Free Trade Zones; development for the regions of the country through projects that would probably not have implemented without this figure, as well as through the surplus trade balance. This is evident in Colombia and in many international cases, as described below. More than 135 countries prove to be ideal places to promote global value chains, international logistics and added value services.

These factors are reflected in the various effects generated by Free Trade Zones in the country. In fact, the declared Free Trade Zones carried cumulative investments for \$47.8 trillion between 2007 and 2020, nearly three-fold when compared with the commitments undertaken (\$17.7 trillion) for qualification purposes and have generated a total of 137.115 direct, indirect, and related jobs, while their tax costs remain low. These results prove that Free Trade Zones have exceeded their approval requirements and, in turn, have become a vehicle for the country to gain access to global value chains. In terms of foreign trade, the trade balance of Colombian Free Trade Zones registered a surplus of US\$ 1 billion 418.7 million FOB during 2020.

With respect to foreign trade, it is worth mentioning that even though Free Trade Zones do not represent a significant part of domestic exports and imports, their trade balance remains positive. Considering that Free Trade Zone businesses export value-added products, this surplus becomes even more significant. Exports from Free Trade Zones increased by 33.6% in 2019, reaching a surplus of US\$ 1 billion 621 million. Similarly, despite the economic crisis caused by the COVID-19 pandemic, the trade balance of Colombian Free Trade Zones remained in surplus (US\$ 1 billion 418.7 million) during year 2020. The trade balance of Colombian Free Trade Zones reported a surplus of US\$ 1 billion 418.7 million FOB in 2020.

In this vein, if it is acknowledged that the tax system affects investment attraction; therefore, it also affects the competitiveness of the productive apparatus and economic growth, the gains and impact of the Free Trade Zones instrument must also be recognized, which generates strategic investments that contribute to the promotion of productive transformation, entry in international markets and job creation, as exposed above.

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<sup>43</sup> Colombia has one of the highest contribution rates (% of profits) in the world (71.2%), above the Latin American average (53.2%) and the OECD average (34.3%). This is also true for the Commercial Income Tax (CIT), which is set at 32%, higher than the OECD average and Latin America, 23% and 27.4%, respectively.

Below, we expose some comments on the modifications proposed in terms of the benefits applicable to Transitory Free Trade Zones, as well as on the implementation of the VAT in Free Trade Zones:

### **1. Maintaining customs benefits applicable to Transitory Free Trade Zones**

Transitory Free Trade Zones are areas delimited inside the national territory to celebrate national or international fairs, exhibitions, congresses, and seminars which, as shown in the Report, enjoy customs benefits. Specifically, the goods intended for exhibition or those required for the event, are considered outside the National Customs Territory; therefore, they are not encumbered with customs duties, namely tariffs and VAT. This applies if these goods do not enter the Customs Territory.

Even though we agree that they do not generate an investment or job creation, as it occurs with both modalities of Permanent Free Trade Zones, the truth is that they have been a valuable instrument to attract fairs and events, as well as to dynamize tourism oriented to meetings, which incidentally implies investments in infrastructure, such as the construction of event and exhibition venues. This type of tourism is a great source of direct and indirect jobs, as well as a dynamizing agent of the national and regional economy with the promotion of the hotel and tourism, gastronomy and commercial sectors, among others.

That said, we also agree that a modification to the customs norms that will lead to the creation of a figure that imposes similar conditions could have the same effect, provided that the same is accompanied by facilitating and accompanying instruments by the competent public bodies.

In the opinion of the Ministry of Commerce, Industry and Tourism, only once there is an alternative figure that provides the same benefits in place, we could proceed with the abolishment of the Transitory Free Trade Zones regime. However, it is worth highlighting that any modification implies a reform to Law 1004 of 2005, which established this special regime.

A potential alternative would be to adhere Colombia to the Istanbul Convention, aimed towards adopting a document (ATA Carnet), which will allow for the temporary import and export of goods temporarily free from taxes and tariffs. This initiative is in process of approval in the Congress of the Republic and was approved in the first debate.

### **2. Special VAT Regime for Free Trade Zones**

Under the Free Trade Zones regime, goods entering, from third-party countries and those acquired from the National Customs Territory by industrial users of Free Trade Zones, are exempt from VAT.

First, it is worth clarifying that this special VAT regime does not generate any loss of tax income. In this respect, goods that do not pay VAT when entering the Free Trade Zone intended for export markets are not subject to VAT; if they are sold to the domestic economy, these must pay VAT on the final value of the good. The modification introduced with Law 2010 of 2019, which modified the tax base used to settle the sales tax of finished products in Free Trade Zones, establishing that the same applies to foreign and domestic inputs, correcting the former differential treatment as well as the loss in tax revenues. In fact, this modification removed the differential treatment for producers located in Free Trade Zones declared before 2012, as well as for producers inside the national territory, as it established the same VAT base for all Free Trade Zones, regardless of their year of declaration.

As a rule of thumb, the countries Colombia competes with in terms of attracting investments apply a 0% VAT rate on imports, exports, and purchases of Free Trade Zone businesses to the domestic economy. All Free Trade Zone regimes in Latin America are based on the concept of extraterritoriality, which means that the goods entering Free Trade Zones are not subject to customs duties, including VAT, as long as they remain inside the Free Trade Zone. Even countries such as Mexico, which does not have a solid Free Trade Zone regime in place, employ mechanisms aimed towards attracting international investments by

deferring the VAT and other import taxes. On the other hand, out of the 37 members of the OECD, the three Latin American member countries, namely Chile, Mexico, and Colombia, employ Free Trade Zone regimes with VAT exemptions while the goods remain inside the Free Trade Zone. Due to this, removing this benefit would generate a disadvantage for Colombia when compared with other destinations that also struggle to attract investments.

As we exposed in the various meetings of the Commission, as well as in the document with the respective comments submitted on January 23, we cannot fail to express our concern regarding the recommendation made by the Commission in terms of applying the general VAT regime on Free Trade Zones, since it undermines an incentive inherent to the nature of the regime, which is applied by the rest of the countries in the world.

Abolishing this incentive goes against the international legal framework and the principle of extraterritoriality established in the Kyoto Convention, which establishes the possibility to grant an exceptional treatment to Free Trade Zones, by virtue of which goods introduced into those areas are not subject to import taxes or tariffs, as they are deemed to be outside national territory. Removing the special VAT treatment implies distorting the essence of Free Trade Zones, which would render the regime unattractive for companies and make Colombia lose competitiveness against other countries.

Furthermore, as we argue below, we cannot agree with the recommendation in the Report related to the non-approval of Special Permanent Free Trade Zones until the general VAT regime is not implemented.

### **3. Special Permanent Free Trade Zones**

Emphasis should be placed in the extent and importance of this Free Trade Zone modality in this country, with regards to the subsidiary recommendation, which states that if the Government is not capable of changing the VAT treatment of existing Free Trade Zones, it should definitively refrain from creating any Special Permanent Free Trade Zone in the future.

Special Free Trade Zones have greatly proven their impact in terms of investment, jobs, and particularly regional development. These generated over 60% of the jobs in the Free Trade Zones regime with 267 jobs, on average. Furthermore, Special Permanent Free Trade Zones are a significant source of investment in our country, exceeding the commitments undertaken to qualify businesses. This investment is focused on high added value sectors, particularly the activities related to machinery and equipment, which accounted for 75% of Special Permanent Free Trade Zones, compared with 49% of Permanent Free Trade Zones (ANDI, 2018).

Finally, it is worth highlighting that Special Permanent Free Trade Zones do not represent an exclusive figure in Colombia. For instance, Free Trade Zones in the United States not only support trade, but also manufacturing. Similarly, these are not only located in ports of entry, but also miles away from those ports, as well as in isolated factories.

In conclusion, we would like to attract attention towards the boost that the Government of President Ivan Duque has given to the Free Trade Zones Regime. The National Development Plan 2018-2022 “Pact for Colombia, Pact for Equity” contemplates repowering the Free Trade Zones instrument, to promote ambitious corporate projects aimed towards entering global value chains, investment in technology and innovation, highly qualified job creation, compliance with international quality standards, sophistication of offered goods and services and value adding actions, in order to increase the amount of investment directed towards generating greater productive efficiency in enterprises.

As you know, 10 Free Trade Zones have been declared since August 2018 and 3 have been extended (Bogotá, Zofía and Tocancipá) with investment commitments of approximately 4.1 trillion pesos and a potential to generate over 1,200 jobs and expand the supply of electricity, health and port services in the

country. It is also worth mentioning that 120 Free Trade Zones have been declared (41 Permanent and 79 Special Permanent Free Trade Zones) during the 13 years of existence of this regime, generating over 136 thousand jobs and materializing approximately 48 trillion pesos in investment commitments.

From a regulatory point of view, this Government has pushed two actions aimed towards strengthening the regime in the long-term: the modernization of the regime (currently in progress) and the regulation of extensions (Decree 1054 of 2019).

From a tax point of view, we cannot deny the adverse effects of losing potential investments, which surely would seek other territories with more attractive tax benefits. In this respect, it is worth mentioning that the last Legal, Economic and Fiscal Impact Study on Free Trade Zones prepared by the Chamber of Free Trade Zone Users – ANDI and the consultancy firm Araújo Ibarra 2020, points out that: “(...) the effective tax rates of Free Trade Zones exceeds the sector average with respect to the companies in the TAN - National Customs Territory-. In other words, in net terms, the Government collects more from companies in Free Trade Zones than from those in the TAN, which are normally less profitable. After calculating the investment of the Government as well as the additional revenues collected from taxing companies that solely and exclusively operate thanks to the existence of the Free Trade Zones regime, the results show a positive tax impact for the Government at all levels of the WACC taken into consideration (acid scenario of 12%, intermediate of 14% and broad of 16%) throughout all the years covered in the study (2014 – 2017)”

From a legal stability point of view, we would be generating uncertainty because of the change in the rules of the game, which would not only cause a loss of reputation as a country that welcomes investment, but also could potential legal requirements that will be just as costly for the country.

From an international competitiveness point of view, Colombia would lose a valuable investment attraction instrument that is present in other 16 Latin American countries, many with Corporate Income Tax rates below the 20% offered by Colombia.

COUNTRY	FTZ INCOME TAX	TAN INCOME TAX
Argentina	35%	35%
Puerto Rico	21%	21%
Ecuador	5% Reduction	25%
Colombia	20%	33%
Brazil	75% Reduction	15%
Aruba	2%	25%
Curacao	2%	22%
Paraguay	0,50%	15%
Chile	0%	24%
Costa Rica	0%*	10%-30%**
Cuba	0% (first 10 years) y 12% (thereafter)	35%
El Salvador	0%*	25%-30%
Guatemala	0%	7% or 25%

Haiti	0%*	30%
Honduras	0%	25%
Nicaragua	0%*	30%
Panama	0%	25%
Peru	0%	29,50%
Dominican Republic	0%	27%
Uruguay	0%	25%

Source: Free Trade Zones Association of the Americas (AZFA) 2019

\*In these countries, the income tax suffers gradual increases over time.

\*\* In these countries, the income tax varies depending on the type of company

Due to the reasons exposed above, we cannot support the recommendations made by the Commission in terms of removing Transitory Free Trade Zones and applying the general VAT regime, much less the non-approval of more Special Free Trade Zones if the general VAT regime is not established. This would be utterly inadvisable amid the current health, social and economic crisis the country is facing, due to a loss of opportunities for attracting investment projects that would generate high-quality jobs and bring growth and development.

Yours faithfully,

**LAURA VALDIVIESO JIMENEZ**  
Vice-Minister of Foreign Trade

Copy to:

**JUAN PABLO ZÁRATE**  
Vice-Minister  
Ministry of Finance and Public Credit

**LISANDRO JUNCO RIVERA**  
General Director  
National Tax and Customs Administration (DIAN)





# Informe de la Comisión de Expertos en Beneficios Tributarios



Schweizerische Eidgenossenschaft  
Confédération suisse  
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**Embajada de Suiza en Colombia**  
**Cooperación Económica y Desarrollo (SECO)**



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**OCDE**

MEJORES POLÍTICAS  
PARA UNA VIDA MEJOR