The tax reform explained

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- The new tax law (Number 2010 from 2019) lowers the tax burden on business by reducing the corporate income tax rate and introducing new tax breaks. This should stimulate investment and growth but worsens the medium-term fiscal outlook as the foregone revenue from corporations will not be offset by higher taxes on individuals.
- It is likely that the government will need to cut expending to meet its fiscal targets in 2021 and 2022, but it remains to be seen whether a reduction in social spending is politically feasible given the recent social unrest.
- This report aims to shed some light and summarize the most relevant and significant changes made to the tax code in the newly introduced law.

The "Growth Law"

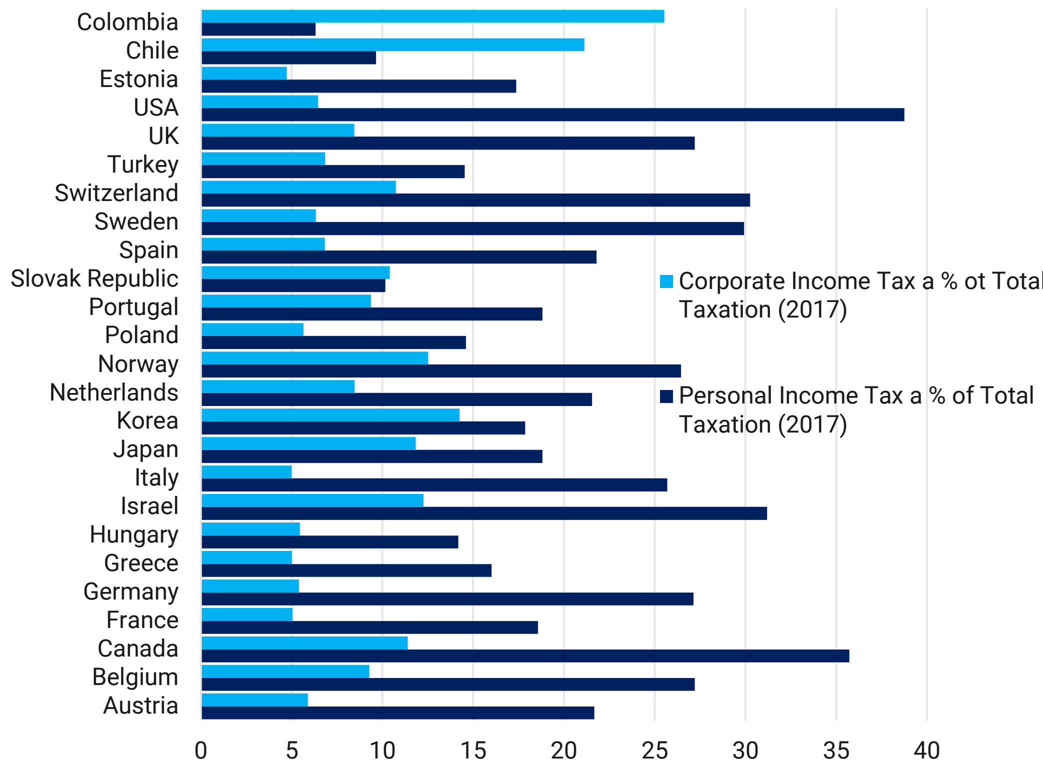
At the end of 2019, the Colombian Congress approved a bundle of new changes to the tax code (*Estatuto Tributario*) with the so-called "Growth Law" (*Ley de Crecimiento*), Law 2010 of 2019, which is basically a new tax reform based on the previous tax bill that was deemed unconstitutional by the Constitutional Court in October 16th, 2019. The Court ruled that the tax reform of 2018 did not have enough discussion and publicity during its transit through congress, thus violating the principle of no taxation without representation. Because of the economic importance of the Financing Law, the court decided to deem it null and void as of January 1st of 2020, forcing the Government to converge once again to present a new tax bill.

The new reform (Law 2010 of 2019), which was given the label of "Growth Law" by the Government, incorporates almost all the modifications to the tax code of Law 1943, including a reduction in corporate taxes, a new tax regime for small business (SIMPLE), tax credits for the VAT paid in the acquisition of fixed assets, among others.

The new law reduces the tax burden on businesses, by lowering corporate income tax rates and creating tax breaks, while raising taxes on individuals. This change is in line with the recommendations made by the previous tax commission (*Comision de Expertos para la Equidad y la Competitivad Tributaria*) and follows common practice in OECD countries (Figure 1). It raises, nonetheless, the question of whether the foregone revenue caused by lower corporate taxes will be offset by a larger revenue from households and from stronger economic growth because of the reform.

The new law also includes a 100% **VAT rebate for the poorest 20% of the population and a reduction in health system contributions by those retirees whose monthly pension is equivalent to 2 minimum wages or lower**. Law 2010 also introduced a VAT three-day break for specific product categories such as apparel and small appliances. **These new measures, which amount to 0.2% of GDP (COP2 trillion), were introduced as response to several social protests carried out against the government and its policies.**

Figure 1. Personal and Corporate Income Tax Revenues as % Total Taxation (selected economies)



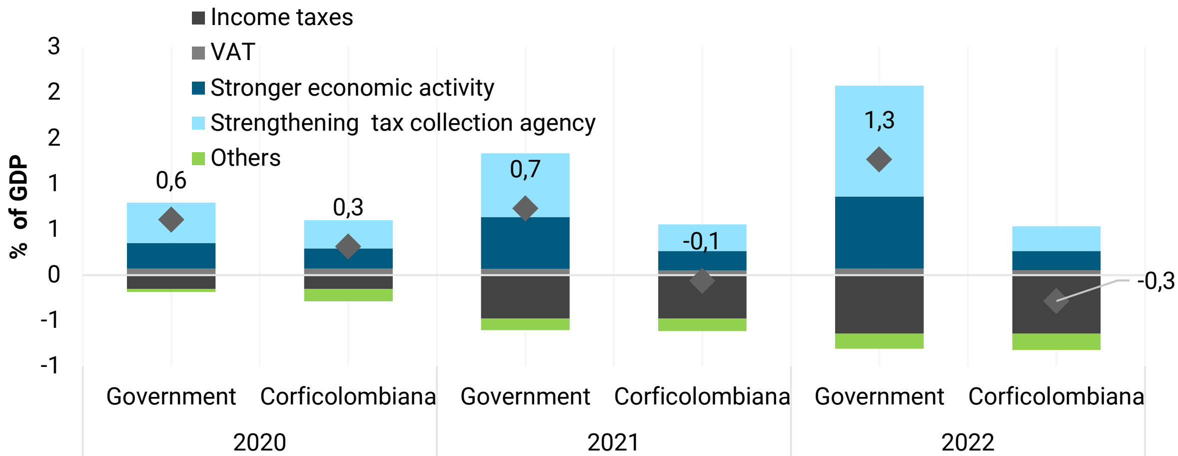
Source: OECD and own calculations.

From our point of view, **the tax reform is revenue-negative and it will have an increasingly adverse effect on revenue after 2020 (Figure 2)**. The government expects that economic growth will further accelerate as a result of lower corporate taxes and that the rolling out of the electronic invoice will have a strong and positive effect on fiscal revenue. We remain skeptical in both fronts. Our growth forecasts are less optimistic, especially in the long-term, where we see the economy growing at 3.5% and not above 4% as the government expects. In addition, while studying the fiscal effects of introducing electronic invoice in other countries in the region, we found that revenue did not grow as fast as the government projects.

According to our calculations, the fiscal outlook remains challenging, particularly for 2021 and 2022. We expect that the government will need to adjust fiscal spending, as it did in 2019, to meet its fiscal targets given the lower revenue associated to the reform in the upcoming years. However, given the relative low approval rate of the president and the social unrest experienced at the end of last year, it remains to be

seen whether a reduction in government spending during the next few years is politically feasible.

Figure 2. Tax revenes associated to Law 2010



Source: Ministry of Finance and own calculations.

Lower corporate taxes.

One of the key elements of the reform is the reduction of the tax burdens on businesses. Law 2010 includes a **gradual reduction in the corporate tax rate from the previous 33% to 32% in 2020, 31% in 2021 and 30% in 2022 and onwards**. The law also reduces the **presumptive tax rate on net equity from the previous 3% to 0.5% in 2020 and 0% afterwards**, and includes tax credits for the VAT paid in the acquisition of fixed assets. It also creates a tax deduction of 50% for the local-paid industry and commerce tax (ICA) in 2021and of 100% in 2022 and from there on.

The reform also introduced a seven-year **tax break for investments on technology and creative industries of local companies**. The tax break is for businesses established prior 2022 whose investments is above COP 157 million (US$46 thousand) and revenue is lower than COP 2.8 billion (US$ 837 thousand). This tax break requires an official approval from the creative industries committee (Comité de Economía Naranja) of the Ministry of Culture. There is a similar tax break for investments on the agricultural sector. The 10-year reduction in income taxes is aimed at promoting new investments that increase productivity in rural Colombia. For the exemptions to become effective, businesses established prior 2019 are required to present projects (by December 31st, 2020) to the Ministry of Agriculture with investments above the COP 53 million level (US$ 16 thousand).

Another tax break included in Law 2010 is **a 20-year reduction in the corporate income tax rate to 27% for the so-called Mega-investments** (*Megainversiones*). Mega-investments should be completed within a 5-year window after authorization from the Ministry of Commerce, Industry and Tourism before January 1st of 2024. All Mega-investment projects need to be larger than COP$ 1 trillion (US$ 300 million), should create at least 400 new jobs (250 jobs if the project has an important technological component). In addition, Mega-investment can depreciate fixed assets with a minimum 2-year window and sign legal stability contracts to guarantee the agreed tax term through the length of the projects. Under the Mega-investments regime there will be no dividend tax on distributed profits and no wealth tax. All projects that meet the above-mentioned criteria could benefit from the tax breaks, except investments on the mining and oil & gas sectors.

The tax reform also extended tax benefits to promote the tourist sector with a 9% corporate tax rate for: i) investments on new or remodeled hotels in cities with less than 200 thousand people prior to 2029 for a period of 10 years; ii) investments on new or remodeled hotels (minimum 50% investment of property value) in cities with more than 200 thousand people prior 2023 and for a 10 year period and iii) new amusement/theme parks, ecotourism, agritourism and new nautical docks for a period of 20 years.

In response to the rise on unemployment rates, particularly for the young, Law 2010 created new incentive to hire people from the 16-28 age group. Companies will be able to deduct 120% of the salaries paid to new hires with a maximum deduction of COP 4 million (US$1.2 thousand) per month. New hires need to have no prior job experience.

The reform also includes a **supplementary rate of 4% in 2020 and 3% in 2021 and 2022, in addition to the standard corporate tax rate, for financial businesses** with taxable income larger than COP 4.3 billion (US$ 1.3 million). With this supplementary rate, the financial sector will be subject to a corporate income tax rate of 36% in 2020, 34% in 2021 and 33% in 2022.

Dividends.

For Colombian residents, **the tax rate on dividends** over COP 10 million (US$ 3 thousand) **fell from 15% (in the prior law 1943) to 10%.** For nonresidents, people or companies and entities, the dividend tax rose from 7.5% to 10%. With these changes, the marginal dividend tax rate is the same for both residents and nonresidents. Withholding taxes apply in all cases except for businesses under the domestic holding company regime (CHC), dividends distributed to parent companies certified by the Chamber of Commerce and Mega-investments, as mentioned earlier.

Personal Income and wealth tax

Law 2010 kept the personal income taxe limit at 95 monthly taxable units (UVT - *Unidad de Valor Tributario*), which amounts to COP 40,6 million of annual income (US$ 12 thousand). Withholding taxes start at the same UVT income level, higher than the 87 UVT limit introduced in Law 1943.

The new tax law raised the marginal tax rates from 33% to 37% to people with annual taxable income above COP 404 million (US$ 118 thousand) and **to 39%** for incomes above COP 982 million (US$ 288 thousand). Law 2010 also includes a flat 1% wealth tax to people with net assets by January 1st of 2020 above COP 5 billion (US$ 1.5 million), excluding housing up to COP 481 million (13.500 UVT / US$141thousand). This tax will apply for 2020 and 2021 and 75% of its proceeds will fund investments on the agricultural sector. Let's recall that tax revenues cannot have a specific destination, unless proceeds are used for investment in social programs (article 359 of the Constitution).

The law maintained the 30% that individuals can deduct from to their taxable income by paying private health insurance, saving on voluntary pension schemes or for the special savings accounts used for paying mortgages (AFC accounts) with a maximum deduction per year of COP 135 million (3800 UVT/ US$ 40 thousand). However, It changed the income tax schedule by defining only three categories: i) capital & labor and non-labor income, ii) pension benefits and iii) dividends. With this change, the tax base will increase as capital & labor and non-labor income are part of the same bag. Another modification, introduced as part of the government's response to judicial branch social protests, is a special tax exemption of up to 50% in labor income for senior court judges and prosecutors under the concept of work related expenses

Law 2010 also extended the reduction of the presumptive tax applied to corporations to individuals. In addition, the new law removed the 2% consumption tax on real estate transactions unsuccessfully introduced by Law 1943. Another change is found in the reintroduction of inflationary component tax associated to nominal returns of financial assets.

The tax amnesty program introduced in Law 1943 of 2018 was extended to 2020, so individuals with undeclared assets and/or non-existing financial obligations either in Colombia or abroad can be subject to a 15% flat tax rate. The rate rose from 13% to 15% in the previous amnesty program and individuals who join the amnesty program are required to pay by September 25th of 2020.

Indirect taxes and health contributions

At the time the reform was being discussed in Congress, social unrest triggered a series of social protests. As a response, the government introduced changes to the bill to reform VAT system aiming at reducing the fiscal burden to the 20% lowest income households living under the poverty level.

Law 2010 introduced VAT rebates for the poorest 20%, which could cost 0.1% of GDP every year. The rebate program will start in 2020 and use existing social programs targeted at poor individuals such as "familias en accion". In addition, **Law 2010 created a three-day VAT holiday on specific dates of the year**. The tax holiday is for specific product categories, such as apparel, sporting goods, toys and small appliances, and only applies when purchases are paid with debit or credit cards. In addition, sellers are required to issue an electronic invoice and to limit the amount of purchases by product category and buyer. The VAT holiday is expected to a have a limited effect on revenue as well as on economic activity.

The government also proposed a reduction of health contributions for retirees with monthly pension up to two minimum wages. The contribution for workers with a pension equal to a minimum wage falls from 12% to 8% in 2020 and 2021 and to 4% in 2022 onwards. For retirees that earn two minimum wages the health contribution falls to 10% in 2020 and onwards.

Law 2010 kept the VAT changes introduced by Law 1943 for sugary beverages and beer. With these changes, VAT in these two sectors apply for all the stages in the supply chain and not only in production.

The reform excluded some goods and services from the VAT such as the commissions charged by financial institutions for the administration of mutual funds (FICs), plastic surgeries, pharmaceutical products, bicycles, skates and electronic scooters that cost less than COP 1.8 million (50 UVT/ US$ 524).

SIMPLE regime

Law 2010 kept the SIMPLE regime introduced by Law 1943. The SIMPLE regime seeks to simplify compliance of entrepreneurs and small and medium-sized firms. This new regime is for domestic residents either individuals or business, excluding financial entities. Nonresidents cannot be part of the SIMPLE regime. Taxpayers can voluntarily adopt it and serves to consolidate the filing and payment of the corporate or personal income tax, industry and commerce tax (ICA), the national consumption tax and the VAT in case of mom and pop stores, minimarkets and hairdressers. People and business can opt for the SIMPLE regimen whenever their annual income is below COP 2.8 billion (80,000 UVT/ US$ 837 thousand). In this regime, taxes are computed based on gross income and no deductions area allowed. Tax rates vary from 1.8% to 14.5% depending on annual gross income and the business activity of the firm or the entrepreneur. If income is derived from food and beverages sales, an additional 8% consumption tax applies. If an individual or a business gets income from two different activities, the highest marginal rate applies. Taxpayers can choose to file their yearly tax forms (for the previous fiscal year) under the SIMPLE regime by January 31st. of the following ongoing fiscal year.

During 2019, the first year of the SIMPLE REGIME, created in 2018, more than 6,300 enrolled in the new regime, of which 67% are business. In terms of enrolling, SIMPLE has been quite successful in comparison to the previous special regime for small business, the so-called Monotributo, that only managed to enroll less than a third during two years in operation. **It remains to be seen whether the SIMPLE will help firms to become formal or whether it will be used mainly in an arbitrary manner between the two systems**. Particularly, the new regime could reduce the effective tax rate of high-income individuals. Under the 2010 and SIMPLE figure, people with an annual gross income of above COP 1 billion (30,000 UVT/ US$ 314 thousand) have a maximum marginal tax rate of 14.5% under the category of professional services, consulting and scientific activities, being much lower than the 39% (law 1819 from 2016) introduced for the normal regime after all deductions are applied.

Electronic invoice

An important element of the tax reform is the strengthening of the tax collection agency DIAN and the rolling out of the electronic invoice with the purpose of reducing tax evasion. Firms in the SIMPLE regime are required to issue electronic invoices and firms will be able to deduce payments to suppliers only if a growing fraction of those payments is supported by electronic invoices. The maximum amount of deducible payments without electronic invoice support is 30% in 2020, 20% in 2021 and 10% in 2022. The new law also stiffens legal terms in relation to tax fraud as typifies tax fraud as a crime, without requiring malicious intent.

Other changes

A tax commission should be created within 4 months of the approval of the law to study the new tax breaks introduce by Law 2010. The commission will be made up by 4 government officials (a representative from DIAN, the Ministry of Finance, Ministry of Commerce and Ministry of Agriculture) and 5 international experts appointed by the Ministry of Finance. The government also needs to present within the next 6 months, a study showing what would be the effects of replacing the current VAT rate which currently stands at 19% (general rate) to a consumption tax of 8%.