Small Firms Tax Regimes and Presumptive Taxes in Chile: Tax Avoidance and Equity

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Abstract

In general, special tax regimes and income tax exemptions create inefficiencies and might destroy horizontal equity (Zee (1998); Auerbach y Hasset (1999); McLure (1999)) and increase inequality (Piketty y Saez, (2003, 2012)). Thus, they are a bad idea for efficiency and equity concerns.

In Chile income taxes represent around 28% of tax revenues and consist basically of a flat corporate tax rate of 20% and a progressive income tax with 7 brackets from 5% to 40%. Personal income taxes are integrated with corporate taxes and, therefore, when profits are distributed corporate taxes paid on are considered a tax credit for personal taxes. In this respect, the corporate tax serves merely as a withholding of the personal tax that must ultimately be paid by the owners of the firm. However, there are two special tax regimes that work differently. One is tax regime for small businesses that allow profits to be taxed only when they are withdrawn by the owners (no corporate taxes).[1] The other one is a presumptive tax regime for small farmers, truckers and miners. Under this regime the tax base is not profits and the tax rate is lower than the corporate tax rate. Farmers pay 10% of the value of their land, truckers pay 10% of the value of the trucks owned, and miners pay 6% of the value of the ores extracted.

As a consequence of these special regimes, two persons with identical incomes may face very different tax rates. A person who earns only labor income pays taxes at a marginal rate that can be as high as 40%, while a person whose income comes solely from small businesses, for example, pays no taxes at all until the profits are withdrawn as dividends. Obviously, this tax gap produces incentives to create small firms for the sole purpose of paying less taxes, leaving all personal savings in the firm as tax-free retained profits. This horizontal inequity generated by the income tax could potentially be only temporary and limited to a financial gain of the cost of money over time, because once the firm's profits are distributed as dividends they are subject to income taxes based on the tax bracket and the marginal tax rate on total income of the firm's owner. In this respect, the scope of the inequity would be limited to the financial gain attributable to the deferral of tax payment. However, Jorrat (2009) shows that less than a third of corporate profits are distributed each year, and that there are many legal loopholes for withdrawing profits without ever paying taxes on them, implying that the horizontal inequity is not only persistent over time but is of substantially greater magnitude.[2]

[1] To be eligible for this tax regime a firm must have annual income of less than US$375,000 and an initial capital of less than US$75,000.

[2] One way of withdrawing profits without paying taxes is to generate expenses in the firm, which actually correspond to household consumption, e.g. through the purchase of automobiles and 4WD trucks or computers. Another alternative is to create debts artificially with related firms or to purchase all the shares of a related firm for a value

The objective of the small business regimes is to provide liquidity to small firms. However, they can also be used by small investment companies owned by a family group whose members can shift their personal income to corporate income. Empirical evidence shows that 52% of all retained earnings in Chile in 2006 are reported in family firms of this type, the owners of which belong to the highest income decile and make wide use of these special tax regimes (Jorrat, 2009).

The objective of presumptive taxes is to reduce compliance and enforcement costs. However, they create incentives for keeping firms small (Engelschalk (2004)) or switch to the informal sector (Thuronyi (2004), Bird (2007)) and can be used to hide income and pay less taxes (Tekper (2003), Bird (1974, 1992)). For this latter reason they should be used only when tax authorities face difficulties to measure the tax base and enforce tax payments of some taxpayers (Slemrod y Yitzhaki (2002)). In Chile there is no reason to keep using presumptive taxes, as many firms operate in financial markets and even pay VAT taxes online.

With the purpose of studying the magnitude of tax avoidance of these special tax regimes and their effects on horizontal equity, I simulate two tax reforms. The first one eliminates both tax regimes. The second one replaces them by a cash flow tax for small firms. For this purpose I use administrative data from the Chilean IRS of 18,924 taxpayers, which were randomly sampled (but oversampling taxpayers in higher marginal tax rate brackets). For each taxpayer I had access to all tax forms for 2010 (the ones file by each taxpayer and also the ones filed by other reporting information about the taxpayer, like financial institutions, or reporting taxes withheld, like employers). Additionally, I had access to all tax forms of all firms in the country, which allowed me to match to every taxpayer the share of profits of every firm the tax payer owns directly or indirectly (for the latter I had to track cascades of firms owned by other firms until I reached the taxpayers). For the firms under presumptive taxes I estimated profits using information from their VAT tax forms filed and some third-party reported financial information.

The results show that 85.6% of the profits from firms under presumptive taxes belong to the top income decile. Even more impressive is the finding that a large fraction of these profits belong to taxpayers in the 40% tax rate bracket, where the 0.4% richest taxpayers are. Most of these firms report activities in several economic sectors -not only farming, trucking and mining-, which facilitates to shift profits from economic activities that are not allowed to use presumptive taxes and report them as the result of economic activities in farming, trucking or mining.

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that yields a tax-free capital gain. It is also possible to have children over the age of 18 as shareholders or partners: if they are not working, they can each withdraw amounts up to the tax-exempt threshold (around US12,000 a year).

Similarly, 77.6% of the profits from firms under the small business tax regime belong to taxpayers in the top income decile and also a large fraction to taxpayers in the top tax rate bracket.

The tax reforms simulated, without behavioral responses, would increase income tax revenue in around 9%-12%. However, taxes paid by the owners of firms under presumptive and small business tax regimes would almost double. The number of taxpayers in the 40% tax rate bracket would also double.

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