

Tax professionals' view of the Spanish Tax System: Efficiency, Equity and Tax Planning

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PROVISIONAL VERSION

Abstract: Under tax systems there is a trade-off among public finance objectives as it is not possible to meet all of them at the same time. In the paper we analyze some of the main distortions that current taxes cause due to their wrong designed, particularly regarding efficiency, equity and tax planning. According to the results of a survey conducted among tax professionals, those distortions are true. Their views corroborate what the public finance literature usually points out.

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1. INTRODUCTION

Tax systems are usually the result of often opposing aims and compromises. For instance, a lump sum tax is efficient, but it is not fair as everyone would pay the same regardless his ability to pay. A comprehensive income tax with a very progressive tax schedule can be fair, but high marginal tax rates however can be very inefficient as higher marginal tax rates cause higher economic distortions (excess burden). Taxpayers do react to taxes changing their behavior, which in addition to inefficient can finally be considered inequitable.

Either an inheritance tax or an annual wealth tax are usually based on equity grounds, particularly on progressivity. However, if rules offer concessions for business assets, with the aim of having a positive supply side effect, tax planning may cause inefficiency and inequitable results. Individuals can reorganize their assets, in order to qualify for the concessions, particularly, wealthy well-advised taxpayers. For that reason, we believe it is interesting to know tax professionals' opinion, as they have a more practical perspective of the issue. In fact, we can find some papers in the literature (**), where tax experts' opinion is considered.

The aim of this paper is precisely to know what are tax professional' opinions regarding key issues of the Spanish tax system, if they are consistent and if they can cast some light with the aim of improving the system.

2. Efficiency, equity and tax planning

Taxes cannot meet all public finance objectives and usually we find trade-offs among aims. We next analyze some of these situations in the current Spanish tax system, particularly taking into account efficiency, equity and taxing planning.

Tax schedules in the personal income tax and corporate tax

It is important to jointly assess personal income tax (PIT) and corporate tax (CT) as both levy income. Statutory tax rates are a key issue of any tax and usually concentrate much attention in public opinion, particularly top marginal tax rates of the PIT even though they usually levy a small proportion of taxpayers. In the 2011 Spanish tax, only 3.52 % of taxpayers reported a general tax income greater than 60,000 euros, which means that the overall majority of individuals are in the first four brackets of the tax schedule. In other words, only a very minute proportion pays the four top marginal tax rates (from 46.9% to 56%, depending on the region)¹. On the other side, the statutory tax rate in CT is 30%, although most incorporated firms enjoy a 25% tax rate for the first 300,000 euros of profits. Therefore, a difference up to 30 perceptual points, that

¹ Although their tax liabilities account for approximately 33% of all revenue yield

already reaches 20 points from income slightly greater than 53.000 euros. So, in Spain, but also in many other countries, an owner of an unincorporated firm has the opportunity to incorporate his activity with the aim of reducing his tax liability. Indeed, De Mooij and Nicodème (2008) explore income shifting from the personal toward the corporate tax base for 17 European countries between 1997 and 2003. And their results suggest that the tax gap between personal and corporate tax rates exerts a significant positive effect on the degree of incorporation as between 10% and 17% of corporate tax revenue can be attributed to income shifting. The literature reminds us the ideal would be that the legal form of a business should make no difference to its tax treatment (e.g. Crawford and Freedman, 2010).

In fact, this is one of the aims of the dual tax that Nordic countries apply since the early nineties, where all capital income, regardless the specific kind of income and if it is obtained by an individual or by a corporation, is taxed at the same reduced flat rate (Cnossen, 1999). This enhances neutrality as all capital income is levied homogeneously, but at the same time improves vertical equity, as tax planning through incorporating business is mainly concentrated on richest individuals (Sorensen, 1994). However, Spain and most EU countries do not have a pure dual income tax, whereby smaller tax rates in CIT may increase tax distortions. The average tax rate of the CIT in the EU has fallen since the beginning of the XXI century (**), although the top marginal rate of the PIT also fell (**). Both trends end with the economic crisis, particularly once countries introduce consolidation measures. Nevertheless, the change is not the same. The CIT and PIT rates have not been reduced any more, but while the former remains stable, the latter has been increased in some countries. Indeed, this is the Spanish case, where top marginal PIT rates have moved from 43% in 2010 to 56% since 2012. The wider the gap between CIT and PIT rates, the more attractive is incorporating activities. Professional opinions' can cast some light about the incorporation of activities.

Corporate tax and efficiency on corporations' financial decisions

Under the most countries' CT, corporations have traditionally deducted payments of interest from taxable base, although are not allowed to deduct dividends. The rule therefore builds a bias towards debt financing. With the arrival of the crisis, more attention has been paid on the effect of CT on the financial decisions of businesses. Empirical studies (Slemrod, 2009; Keen et al., 2010) *** show that this distortion has fostered, but not created, the crisis.

There are two main proposals in the literature to eliminate this distortion. On the one hand, the Comprehensive Business Income Tax (CBIT), which does not allow to deduct payments of interest. Tax revenues rises as tax profits will be higher, although user cost of capital increases as so the level of investment goes down. On the other hand, the Allowance for Corporate Equity (ACE), which introduces an allowance for the cost of equity finance. Various forms of the ACE tax have been used for instance in Belgium and Italy, but other countries, such as Germany, France or ***) have recently limited the deductibility of interest from taxable income. Spain joined this latter group in 2012, as interest payments are deductible up to one million of euros, or 30% of profits when

this latter amount is larger than the former. Rather than improving efficiency in the treatment of debt and equity, the aim of the new limitation is to raise more revenue and moreover to fight against tax elusion practices that often multinationals develop to take profit of different tax levels among countries.

Inheritance and gift tax, the role of regions and equity

Most economies raise relatively little revenue from inheritance and gift taxes.

Furthermore, most individuals would never pay the tax². Nonetheless, the inheritance and gift tax (IGT) generates big attention from the public opinion and the mass media, and often becomes the subject of intense political debate.

IGT is frequently justified on the grounds of fairness. The distribution of wealth is more unequal than the distribution of wealth and has become even more unequal in recent years (Piketty and Zucman, 2013). Supporters of the tax defense that redistribution of wealth should be an objective of the tax system, and therefore levying inheritances is an efficient means to improve wealth distribution. If that is true, the structure of the tax should be fair to reach that aim. Nonetheless, this is not always the case, as the tax law often allows loopholes that people take profit to avoid the tax. And if wealthy well-advised taxpayers can benefit from them, it introduces some doubts about the fairness of the IGT as equivalent wealth transfers pay very different amounts of tax depending on the situation.

In Spain, for instance, business assets can obtain at least a 95% deduction when assessing taxable wealth. Furthermore, once autonomous communities had legal power, many introduced almost full exemption of transfers to spouse and children. In 2012, 11 out of the 17 communities almost do not levied these inheritances, which generates big pressures to do the same to those still taxing them. The inheritance tax is due according to the residence principle of the deceased, regardless where the heirs live. Having second houses is not unusual for those who expect to transfer their wealth to their heirs, which makes easier to change the official place of residence. Although the tax law tries to avoid these changes by requiring a five-year gap before the new region's rule becomes applicable, fighting against tax avoidances practices is not easy. Savings from changing the residence can be very high, as the tax due go from a high amount (generally 34% marginal rate from 800,000 euros of taxable wealth, which can be increased between 20% and 240% depending on the relationship with the deceased and the previous wealth of the heir). up to 36.5% to almost nothing. Furthermore, the gift tax of estates is due to the region where the estate is located, which also makes easier tax planning activities to avoid in the future the inheritance tax without any official change in the place of residence.

3. Results: what do the tax professionals think?

² For instance, only 2% of Americans pay the tax (Boadway *et al.*, 2009).

During November 2012 and as part of the IEB Tax Forum, we launched an anonymous online survey to be conducted among tax professionals. Its objective was to determine the opinion of this expert group as an essential step prior to proposing a reform of the tax system. The number of respondents was 272 scattered throughout Spain³. The appraisal provided by this professional group was largely unanimous and conclusive; however, there are certain specific issues worth noting as supplementary information for designing the tax reform. Below, we discuss the main results, identifying, where they exist, any biased responses.

COMPLEXITY

When assessing a tax system, it is normal to consider its complexity, a characteristic that these professionals are particularly suited to assessing and regarding which they are particularly sensitive because, among other reasons, it tends to hinder their work by increasing legal uncertainty. Asked whether the tax system is more complex than five years ago, 87% of respondents said that it was, above all those working in large tax firms (classified as such by the number of employees). This opinion of the current tax system is in fact independent of a temporal reference point, be it 10, 15 or 20 years.

However, it is also true that in recent years economies have become more complex, mainly, due to globalization, which, for example, has facilitated the mobility of capital, especially big business. Therefore, such an assessment needs to be contextualized. What underlies this increasing complexity? Is it attributable to public sector activity (legislative power or the power of government and the civil service) or to inherent changes in the global economy? And, here again, the responses received were unequivocal: for example, 98% believe the complexity to be due to the constant changes being made to the legislation (legislative power) and 68% to the interpretation of the laws being made by the government, including Spain's Economic-Administrative Courts, while only 19% believe it to be due to issues related to the growing complexity of the economy. In short:

Reality 1a. Our system is becoming (increasingly) more complex and the main cause of this is a hyperactive legislature, even if we take into account factors such as globalization and market complexity.

Based solely on this criterion of complexity, respondents were asked to indicate which taxes were in most need of change, be it in their regulations or in their system of administration. Probably because the experts work mainly with the business world, they identified, first and foremost, the need for changes in VAT (both as regards its

³ The survey was conducted with the support of the Spanish Association of Tax Consultants and the Register of Fiscal Advisors, who forwarded the link containing the questionnaire to their members. The survey was answered on-line using the survey website, EncuestaFacil.com. All responses were anonymous and the Internet Protocol address served as a filter to ensure that the questionnaire was answered only once from the same computer.

regulation and administration) followed by corporate tax (especially, in terms of its regulation) and personal income tax (again, especially, as regards its regulation). Thus, when prioritizing changes, the emphasis is placed on taxes that affect businesses. The number of responses calling for changes in the inheritance and gift tax and the wealth tax was much lower. No significant bias was observed in the answers given, except in relation to the inheritance and gift tax, where the offices located in relatively wealthy AC are less favorable to any change (especially, in its administration), which may denote the existence of some mechanism of tax avoidance of particular relevance in these communities.

Reality 1b. Corporate taxation – and especially VAT – is the area of taxation in which the professionals consider the introduction of regulatory and administrative changes essential.

EQUITY

Above and beyond its actual impact on the activity of the tax professionals, at the social level, a key factor is just how progressive the tax system is, a concept that is associated with the equity of the system. To appraise this, we asked the experts which sectors of society face the highest tax burden, and here the results were even more overwhelming: 95.5% of professionals think – based on their own experience, and not their convictions – that the middle and working classes are the main contributors (and not the rich, which was the alternative option). Therefore, our current tax system appears to be both complex and unfair, if we take as our benchmark of equity the maxim that each should pay according to their economic capacity.

Reality 2. Almost unanimously, the tax professionals conclude that the burden of our tax system falls on the middle classes and not on the rich.

EFFICIENCY

The third point on which we collected the experts' opinion was regarding the distortions generated by our tax system. Such distortions can lead to behavioral changes (e.g., acquisition of a residence as opposed to renting) or the development of mechanisms for tax avoidance or relocation of a tax residence. In any case, whatever the reaction to the distortions of the tax system, they always end up generating inefficiencies. From the responses obtained, we find that the reactions identified by the tax professionals are expressed – by some difference – through tax avoidance mechanisms both with regards to personal income tax and corporate tax and, to a lesser extent, through relocation (internationally in the case of corporate tax and between AC in the case of income tax). Other reactions are reflected in behavioral changes, although these are less important than the above. The most important is the effect of income tax in favor of purchasing a residence, while the impact of corporate tax on corporate financial structure appears to be relatively unimportant.

Reality 3. Taxes generate distortions, which involve the reactions of economic agents primarily through tax avoidance mechanisms and to a lesser extent, relocation.

AUTONOMOUS COMMUNITIES

We mentioned above that there are factors that inevitably generate complexity, one of these is the funding of the autonomous communities, which has given rise to a process of fiscal decentralization. In this sense, it can be considered “inevitable” if the increase in expenditure due to autonomy is matched by an increase in income. Although only 41% of those surveyed consider this process of fiscal decentralization to be at the root of the tax system’s complexity, it undoubtedly needs to be taken into consideration in any reform process. Here again, responses were recorded related to tax avoidance, in particular, the main distortion attributable to decentralization is related to the provision of a fictitious address for the inheritance and gift tax, and to a lesser extent for personal income tax. The use of fictitious addresses is particularly notable in the wealthier AC. Thus, implicitly, this result reveals the importance of tax avoidance mechanisms which, in this case, are magnified by mobility and, probably, by the varying intensity in the fight against fraud conducted by the regional tax administration.

Reality 4. Fiscal decentralization has increased tax avoidance practices (provision of fictitious addresses in response to the inheritance and gift tax and income tax), probably helped by the differences in the intensity of the fight against tax fraud by the regional tax administration, which is also noted in the survey.

TAX ADMINISTRATION

Closely connected to the above issue, the design of the tax administration is fundamental, but probably this institutional question lies outside the scope of what is strictly a tax reform. When the tax experts were asked which tax administration model they would consider as being the best, the answers were not unanimous, although there was one predominant preference stated: a fully centralized tax administration (42%). This was followed by a management system (consortium) integrated within each AC between the Tax Agency and the regional tax administration (29%) and, finally, by variants of a decentralized system. This result is as expected, since tax professionals seek to minimize compliance costs.

Reality 5a. Professionals prefer a centralized tax administration, i.e., they prefer having to deal with only one administration. This is particularly true of the largest tax offices.

The variation in responses allows us to infer certain patterns that explain this ultimate reality. Hence, the following result:

Reality 5b. Professionals working in offices located in the richest AC or in the Basque Country and Navarre, are opposed to the centralized option, however, they fully support the decentralized option, which includes the disappearance of the State Tax Agency.

It is somewhat risky to interpret this result, but it seems that tax professionals working in the richest AC or in the Foral Communities (the Basque Country and Navarre) are (or would be) somewhat uncomfortable working with the State Tax Agency and prefer to work with an administration that is in closer proximity to them. No doubt, this bias should be taken into account when assessing the institutional design of the tax administration.

TAX REFORM

Five realities then that should be of use in designing a tax reform... However, do the professionals consider a tax reform necessary? The response is overwhelming.

Reality 6 and conclusion. 88% of respondents consider a global reform of the tax system to be necessary.

4. Conclusions

The economic crisis has served to highlight the weaknesses of the current system (Esteller Moré and Durán Cabré, 2013). We believe that a fairer, more efficient and less complex tax system is undoubtedly possible in Spain.

In this paper we analyze some of the main distortions that current taxes cause due to their wrong designed, particularly regarding efficiency, equity and tax planning. According to the results of a survey conducted among tax professionals, those distortions are true. Their views corroborate what the public finance literature usually points out.

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