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Chile enacts tax reform

On 29 September 2014, Chile enacted tax reform (Law No. 20.780 published in the *Chilean Official Gazette*), which is effective 1 October 2014.

This Alert summarizes the main aspects of this reform, especially in connection to foreign investors.

Income taxation

Increase in First Category Tax (Corporate Tax)

The First Category Tax will progressively increase from 20% to 25% or 27% (depending on the type of regime the taxpayer has selected to be under) as follows:

- Year 2014: 21%
- Year 2015: 22.5%
- Year 2016: 24%
- Year 2017: The new taxation regimes discussed below will apply
 - Attributed Regime: 25%
 - Distributed Regime: 25.5%
- Year 2018: 27% (only applicable to the Distributed Regime)

New taxation regimes

From 1 January 2017, the Law creates two alternative taxation regimes for taxpayers subject to Corporate Tax (First Category Tax): i) Attributed Regime (Article 14 A or the Income Tax Law-ITL) under which foreign shareholders will be subject to the additional tax (withholding tax on dividends) on the income from their interests held in certain entities in the same year in which the income is recognized, and ii) Distributed Regime (Article 14 B or the ITL) where foreign shareholders will be subject to the additional tax only on the effective dividends distributed by the company.

Each taxpayer will select one regime, taking into account the formalities established in the Law. The selection should be made the last quarter of 2016. If no regime is selected by the taxpayer, the law provides for a default rule as follows:



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- ▶ Individual entrepreneurs and individual limited liability companies: **Attributed Regime**
- ▶ Partnerships (Sociedades de Responsabilidad Limitada) where the partners are only Chilean individuals: **Attributed Regime**
- ▶ Partnerships where one or more partners are legal entities or taxpayers not resident or domiciled in Chile: **Distributed Regime**
- ▶ Taxpayers under the regime established in Article 58 No. 1 (Permanent Establishments): **Distributed Regime**
- ▶ Stock Companies (Sociedades Anónimas y Sociedades por Acciones): **Distributed Regime**

Once the applicable regime is determined, by choice or by default, a five-year holding period is required.

Attributed Regime

Under this regime, the company will be subject to First Category Tax at a 25% rate on its annual taxable income. The same year the company shall attribute such income to its final shareholders that are subject to additional tax (foreign residents) or global aggregate tax (Chilean individual residents); in turn, the shareholders will pay the relevant tax and have the right to use the First Category Tax paid by the income attributing company as a credit.

This means taxpayers subject to additional tax or global aggregate tax will be taxed on the income of the companies in which they have an interest in the year such income

is recognized, regardless of the effective distributions made, with the corresponding credit.

For taxpayers under the additional tax regime (resident of a foreign country), this system translates to a total tax burden of 35% the year the company generates profits (25% paid by the Chilean company and 10% by the shareholder).¹

The attribution of income to be made by a company as explained above is made regardless of the number of companies in a chain of ownership and the taxation regime the other companies in the ownership chain selected. Therefore, a subsidiary subject to the Attributed Regime must attribute the income it derived to its shareholders that have the status of final taxpayers, regardless of the fact that other investment companies or holdings in the chain of ownership are subject to a different regime.

As an exception, attribution of income will not reach local individual or foreign shareholders if a company in the chain of ownership is in a loss position. In these cases, losses will absorb the attributed profits, thereby giving the company in a loss position the right to request a refund for the amount of the First Category Tax paid by the company attributing the income.

For effective distributions from a company under the Attributed Regime, dividends will be subject to the following attribution order:

- i. Attributed Income already taxed: No taxes are imposed

- ii. Exempt incomes: No taxes apply
- iii. Retained Taxable Earnings associated with income generated before 1 January 2017: In this case the former (current) taxation regime will apply
- iv. Excess distributions from prior items (e.g., temporary differences) will be affected by the 35% additional tax with First Category Tax credit, if any

Distributed Regime

Companies under this regime will be subject to a First Category Tax at a 25.5% rate in year 2017 and 27% from year 2018. In turn, foreign and local individual shareholders will only pay the relevant tax on *effective* profit distributions and will be allowed to use as credit the First Category Tax paid by the distributing company, with certain limitations.

This regime is considerably similar to the current taxation regime that operates under the Retained Taxable Earnings Registry (Fondo de Utilidades Tributarias or FUT) as in both cases shareholders subject to the additional tax will only be taxed on effective dividend distributions.

However, under the Distributed Regime, taxpayers subject to the additional tax will have to pay back 35% of the First Category Tax credit already used. This implies that the corporate tax credit is limited to 65% of the tax paid.

The foregoing translates to a total taxation of 44.45% on distributed income.² In the event taxpayers

subject to the additional tax are domiciled in a country that has entered into a Double Tax Treaty with Chile, no 35% refund is to be made, thereby total taxation in this case will be 35%.

In order to determine the taxes applicable to each effective dividend distribution, the attribution order according to this regime is as follows:

- i. Income subject to final taxes (additional tax or global aggregate tax), in which case the additional tax will apply as well as the appropriate credit. This income is the difference between the equity (the higher between book and tax) and the exempt income and less the share capital adjusted by inflation (therefore, it includes book profits in excess of tax), whichever is higher
- ii. Exempt income: No taxes would apply
- iii. Retained Taxable Earnings (FUT) for income generated before 1 January 2017, in which case the former (current) taxation regime applies

Additional considerations on taxation regimes

Tax losses

From 1 January 2017, only loss carryforward will be available. Loss carryback will no longer exist.

The right to offset losses at the level of a holding company to dividends distributed by subsidiaries (with the corresponding right to obtain a refund) will still be available.

Reorganizations

Tax-free reorganization rules remain unchanged, and conversions, mergers and demergers are still permitted without triggering taxable events; however, the company that is converted, created or absorbed should be under the same regime before the reorganization until it completes the mandatory five-year period. If a company is subject to the Distributed Regime and the same is dissolved or merged into an entity subject to the Attributed Regime, a 35% tax on accumulated profits will apply.

International tax rules

Excess indebtedness rules

New excess indebtedness rules are introduced, as well as amendments to the existing rules in connection with the following matters:

- ▶ The 3:1 debt to equity ratio remains unchanged; however, in order to determine the debt, all loans, granted by local or foreign entities, whether related or not, shall be included (before this amendment only loans granted by foreign related parties subject to 4% withholding tax were included)
- ▶ The 35% penalty tax only applies to payments to related entities subject to the 4% withholding tax or not subject to withholding taxes
- ▶ The concept of related company now applies to all kinds of guarantees granted by the group companies

These new rules will apply only to loans granted after 1 January 2015.

Recognition of foreign passive income (CFC rules)

In accordance with new Article 41 G of the Income Tax Law, foreign source income will continue to be taxed on a cash basis as a general rule. Additionally, from 1 January 2016, taxpayers domiciled in Chile will be taxed on an accrual basis on the passive incomes generated by their “foreign controlled entities.”

According to these new provisions, control will be deemed to exist over a foreign entity when:

- ▶ 50% or more of the capital, profit or voting rights, are directly or indirectly owned by a Chilean taxpayer.
- ▶ The foreign entity is domiciled in a country or territory with low or no taxation (preferential tax regime, as explained below), unless proven otherwise.

The concept of passive income extends to income derived from dividends (unless the profits were generated by controlled operating foreign companies), interest and intellectual or industrial property rights. In addition, passive income shall also be income from Chilean source, if it is associated with the acquisition of depreciable property or if the same is subject to a withholding tax rate lower than 35%. In any case, passive income triggered by foreign controlled entities is not subject to taxation if the passive income is not above 10% of the company's income.

Taxpayers have the right to credit taxes paid or owed abroad against passive income recognized in Chile if Chile is the direct shareholder. If

the investment is not directly held by Chile, only taxes paid by the controlled entity would be creditable if the controlled entity is domiciled in a Treaty country. These credit rules require clarification and the Internal Revenue Service should issue the relevant administrative regulations.

Preferential tax regimes

The concept of a preferential tax regime has been established by the Law to enhance the current list of tax havens. This classification means that royalty, technical service and interest payments are deemed made to a related party and the foreign entity is deemed to be a controlled entity.

According to the new provisions, any jurisdiction where at least two of the following assumptions exist will be considered a preferential tax regime:

- ▶ The effective tax rate on foreign source income is below 17.5%
- ▶ No convention for the exchange of information for tax purposes has been executed
- ▶ Legal systems are not based on the Organisation for Economic Cooperation and Development (OECD) nor United Nations (UN) guidelines on Transfer Pricing
- ▶ The jurisdiction imposes legal limitations on its tax authorities that prevent them from requesting information and/or using and disclosing such information to foreign countries
- ▶ The jurisdiction's laws and regulations are considered as preferential regimes for tax purposes by the OECD and the UN

- ▶ The jurisdiction imposes taxes under a territorial system

Notwithstanding the foregoing, country members of the OECD will not be considered preferential tax regimes.

Capital gains tax

The First Category Tax regime as a sole tax applicable to capital gains derived from the sale of shares or social rights is eliminated from 1 January 2017. Therefore, the sale of shares or quotas in a Chilean company performed by foreign residents will, as a general rule, be subject to a total tax burden of 35%, unless a special tax regime applies, i.e., exemption or no taxation (for example, shares acquired before 1984 or listed shares) or sales under special rules contained in a Tax Treaty.

In addition, if capital gains apply to indirect transfers, the capital gains can be charged to the Chilean subsidiary that is transferred.

On the other hand, interests related to investment in local companies will be deductible, regardless of the type of entity.

General Anti-Avoidance Rules (GAAR)

One year from the publication of the law, new substance over form rules will become effective. These new rules give the Chilean Internal Revenue Service (IRS) the authority to challenge a transaction due to abuse or simulation and to request payment of the relevant taxes that would have applied, but for the abuse or simulation.

According to the new rules, abuse will exist when taxpayers circumvent, totally or partially, a taxable event, reduce the tax base or tax obligation, or delay or defer the creation of such obligation, without a reason different from a purely tax motivation. In turn, simulation will be deemed to exist when the legal acts or business activities of taxpayers conceal the occurrence of a taxable event or the nature of the elements of the tax obligation, or the real amount or creation of the taxable event.

The Tax Courts may rule on the existence of abuse or simulation in a given situation; however, the burden of proof is on the IRS.

Anti-abuse rules apply to transactions carried out after the entry into force of the substance over form rules; therefore, all prior transactions will be subject to the rules currently in force.

Additional considerations

Nondeductible expenses

The regime applicable to nondeductible expenses remains unchanged; however, the penalty tax rate increases from 35% to 40%.

Goodwill

At present, the goodwill arising out of a merger must be allocated to the non-monetary assets transferred due to the merger up to the market value thereof.

Should there be an excess, the same is treated as an amortizable asset for a 10-year period (1/10 per year).

Effective 1 January 2015, goodwill arising out of a merger in excess of the allocation to non-monetary assets up to the market value thereof will be deemed a non-amortizable intangible.

Deduction of intra group remittances abroad

A new requirement has been introduced for the deduction of service related expenses, royalties, interest, freights, insurance, leases and all types of income contemplated in Article 59 of the Income Tax Law paid to foreign related parties as follows:

- ▶ The applicable withholding tax should have been declared and paid, if appropriate
- ▶ The remittance of funds abroad should have been effectively made

Capital repatriation rules

A capital repatriation regime is established only for year 2015 according to which Chilean taxpayers will be able to make a statement to report all such foreign assets or profits that had been acquired before 1 January 2014.

Once the statement is filed, an 8% sole tax will apply on the total amount reported.

Under these rules, taxpayers are not required to actually repatriate their property or funds to Chile and the benefit in this case is that no other taxes whatsoever would affect the distribution of repatriated

property or funds to the final shareholders (Chilean individuals or foreign residents).

Taxpayers under this regime will need to conform to the foreign exchange obligations established by the Central Bank of Chile in accordance with its Constitutional Organic Law as and when determined by the referred institution.

In addition, taxpayers under the First Category Tax regime must now comply with an annual obligation, regardless of whether they select the capital repatriation rules or not, which is to submit by 30 June of each year, a statement to the Chilean IRS reporting all the investments made abroad during the preceding year. If no statement is submitted, those investments abroad will be deemed, unless proved otherwise, dividends subject to the taxation applicable to non-deductible expenses.

32% sole tax on FUT

The Tax reform gives taxpayers under the First Category Tax regime the right to pay a 32% tax on the accumulated Retained Taxable Earnings Registry (FUT) and use as credit the First Category Tax paid on the referred FUT.

To exercise this right, the following requirements must be met:

- ▶ Taxpayers under the First Category Tax regime must have initiated their operations before 1 January 2013.

- ▶ As of 31 December 2014, they must have accumulated FUT.
- ▶ The right must be exercised during 2015.
- ▶ The tax must be levied against the portion of the retained earning balance in excess of the average annual amount of the total withdrawals, remittances or distributions annually made by the shareholders over the last three years.

Once this tax has been paid, profits will be deemed revenues not representing income for distribution purposes.

The IRS needs to regulate the procedure to apply this alternative taxation system.

Value Added Tax

Under the Tax Reform Law, the assumptions used to apply the Value Added Tax will now also cover the customary sale of immovable property. This change will take place from 1 January 2016.

Stamp Tax

The Stamp Tax rate will double from 1 January 2016, as follows:

- ▶ The monthly rate will increase from 0.033% to 0.066% and the maximum rate will increase from 0.4% to 0.8%.
- ▶ The rate applicable on documents issued on demand or without maturity date will increase from 0.1666% to 0.332%.

Endnotes

1. The initial tax reform bill established a mandatory 10% withholding at the level of the company that is attributing the income on behalf of the taxpayer subject to additional tax; however, that requirement was eliminated.
2. For distributions made in year 2017, the effective rate would be 43.925%.

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