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International Tax

# Chile Tax Alert

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## Sweeping tax reform bill presented to congress


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Chile's new president, Michelle Bachelet, presented a comprehensive tax reform bill to the national congress on 1 April 2014. The proposed reform—which is broader than anticipated—primarily aims to increase tax revenue to fund an extensive reform of the education system, but also is designed to provide for a more equitable distribution of the tax burden, promote investment and savings and reduce tax avoidance. Many of the proposed changes would have an effect on companies (both domestic and foreign) doing business in the country. The most important proposals include the following:

- A gradual increase in the corporate income tax rate;
- A shift from shareholder/partner taxation on a cash basis to taxation on an accrual basis;
- New restrictions on interest deductions;
- New restrictions on payments to related entities abroad;
- The introduction of controlled foreign company (CFC) rules;
- The introduction of a general anti-avoidance rule; and
- Repeal of the foreign investment statute.

### Income tax rates

The bill proposes an increase in the first category income tax rate on corporate income (currently 20%) over a four-year period, as follows: 21% in 2014, 22.5% in 2015, 24% in 2016 and 25% in 2017.

The maximum personal income tax rate, however, generally would be reduced from 40% to 35% as from business year 2017.

### Taxation on accrual basis

A fundamental structural change related to the taxation of shareholders and partners would be made to the tax system as from 2017. Under the existing rules, business income derived by an enterprise is subject to the 20% first category income tax, but such income also is subject to income tax when distributed to the shareholders/partners of the enterprise, at rates that vary depending on whether the shareholder/partner is resident or nonresident. The tax paid by the enterprise may be used as a credit against the tax liability of the shareholders/partners (with

a special ledger, known as the “FUT,” used to track retained profits and the relevant tax credits).

Under the current rules, shareholders and partners generally are taxed on a cash basis, i.e. they are not taxed on the business profits of an enterprise until the profits actually are distributed. Under the proposed reform, the shareholders/partners would be subject to taxation on an accrual basis, i.e. taxable profits generated at the entity level would be attributed to the entity’s shareholders/partners (whether resident or nonresident) at the end of the calendar year. This would result in final taxes (global complementary income tax (0%-35% for Chilean resident individuals) or additional withholding income tax (35% for nonresidents)) being applied in the year in which the income is accrued, regardless of whether the profits are withdrawn or distributed to the owners. The first category income tax still would be creditable against the owners’ tax liabilities.

According to the draft reform, the annual profits of an enterprise would be deemed to be automatically distributed to its shareholders/partners at the calendar year-end, and enterprises that attribute income to their resident shareholders/partners would have to withhold 10% of the income to be attributed. Taxpayers (other than publicly traded corporations) would not be subject to the withholding obligation if their shareholders/partners or co-owners include only individuals domiciled or resident in Chile. Attributions to nonresident taxpayers would be subject to a 35% withholding tax, although this rate could be offset by a credit for first category income tax paid on the attributable profits.

As part of these changes, new recordkeeping requirements would be imposed and various transition rules would apply for years 2015 and 2016.

## Anti-avoidance rules

The proposed bill contains several measures designed to prevent the avoidance of tax:

***Limits on payments to foreign related parties* –** Certain expenses incurred on transactions with nonresident parties that are directly or indirectly related to the Chilean taxpayer would be deductible only in the calendar year in which the expenses are paid, credited to an account or made available. In addition, to claim a deduction, the Chilean taxpayer would be required to have paid and declared the corresponding withholding tax (except for payments that are exempt from withholding under domestic law or an applicable tax treaty). This measure would apply as from 1 January 2017.

***Capitalization of interest* –** Interest and other financing expenses arising from loans or credits used, directly or indirectly, to acquire equity rights, shares, bonds and, in general, any type of capital formed by assets other than real property would not be deductible as an expense; instead, such expenses would be capitalized proportionally as part of the cost of the assets. This rule would become effective as from the first day of the month following the date the new law is published. This rule also would apply to interest incurred with unrelated parties.

***Thin capitalization rules* –** The draft bill would modify the thin capitalization rules that impose a special tax on interest on debt that exceeds a debt-to-equity ratio of 3:1. The new provision would affect interest and any other expenses relevant to financing, such as commissions and remuneration. Although the 3:1 debt-to-

equity ratio to determine the existence of excess indebtedness would be maintained, excess indebtedness also would be deemed to exist if financing expenses exceed 50% of the taxpayer's net taxable income for the period, before such expenses are deducted. For these purposes, certain adjustments would need to be made to net taxable income. In addition, for purposes of determining excess indebtedness, not only foreign debt, but also debt incurred with Chilean resident parties would be taken into account. The new rules would apply as from 1 January 2015.

***Controlled foreign company rules –*** CFC rules would be introduced to prevent the deferral of tax on foreign-source income. The rules would require Chilean resident taxpayers to include currently the income of nonresident entities that are deemed to be CFCs.

The bill defines "control" in terms of participation in the capital, profits, voting rights or rights to appoint directors or administrators for an entity. However, an entity would be deemed to be a controlled entity (irrespective of the participation or rights mentioned) if the foreign entity is domiciled in a country with low taxation or an otherwise preferential tax regime. Passive income for purposes of the CFC rules would comprise dividends, withdrawals of profits, interest, capital gains and royalties, among other income. The CFC rules would apply as from 1 January 2015.

***General anti-avoidance rule (GAAR) –*** The Chilean tax authorities would be authorized to challenge agreements, structures or activities of companies that are carried out for the main or sole purpose of avoiding the payment of tax. The tax authorities would be able to deny tax benefits obtained through tax-avoidance planning and penalize the taxpayer, as well as its tax adviser who participated in the design of the structure. Taxpayers would be able to challenge the application of the GAAR before the courts.

Abuse would be deemed to exist for purposes of the GAAR when a taxable event is entirely or partially avoided, the tax base or the tax liability is decreased or a tax obligation is postponed or deferred through acts or business reorganizations, including mergers, spin-offs, transformations and other forms of corporate or business reorganizations.

Further, the Chilean tax authorities would be granted broad authority to conduct audits and to take steps to access information necessary to carry out an audit. They also would be granted the power to access information on purchases paid electronically (by credit and debit cards), and to employ statistical methods to determine tax differences.

***Transfer pricing rules –*** The penalty tax collected on disallowed expenses and differences determined by transfer pricing adjustments would be increased from 35% to 40%, as from 2017.

## Indirect taxes

Effective 1 January 2016, the reform bill would extend the scope of VAT beyond construction activities to include the sale of real estate, and the special VAT credit for construction companies would be limited to residences with a price less than or equal to 2,000 UF.

The stamp tax on loans would be increased from the current 0.033% and 0.4%

rates to 0.066% for each month or fraction thereof, capped at 0.8%. For credits collectable on demand or without a maturity date, the applicable rate would be increased from 0.166% to 0.332%. The rate on extensions or renewals without a maturity date also would increase.

## Benefits for small and medium-sized companies

The proposed reform would introduce several incentives to promote investment by small and medium-sized companies:

- Small companies would be entitled to deduct 100% of the costs of investments in fixed assets in the year of acquisition;
- Medium-sized companies would be eligible for extra accelerated depreciation, calculated by dividing an asset's useful life by 10;
- The rules regarding the tax credit for the acquisition of fixed assets by very small, small and medium-sized companies would be modified; and
- The simplified tax regime, which provides an exemption from the requirement to maintain full accounting records, would be extended to companies with annual sales of up to approximately USD 1 million.

## Other measures

- The foreign investment statute would be repealed as from 1 January 2016, with the result that the Foreign Investment Committee would not be able to enter into any new foreign investment contracts. However, parties with existing foreign investment contracts would continue to be governed by the regulations applicable to their contracts.
- The tax reform would amend the taxation of capital gains derived from the disposal of real estate and shares (both measures would apply as from 1 January 2017).
  - The tax exemption for gains from most transfers of real property would be repealed (except for gains derived from the sale of a primary residence, unless the sale was made to a related party). The bill also would change the determination of the tax base for determining the gain on the sale.
  - The bill would repeal the provision that permits the first category income tax to be applied as a single tax on the sale of certain shares and equity rights. Such gains would be subject to the general regime for payers of the first category income tax who declare income on their full accounting records. For taxpayers subject to global complementary income tax or additional withholding income tax, the capital gains would be subject to both the applicable final tax and first category income tax if the taxpayers held the shares for one year or less. If the shares were held for more than one year, the capital gains would be subject to only the applicable final tax. Finally, the bill would modify how the tax basis is calculated for capital gains tax purposes.
- For the 12-month period following the enactment of the law, all companies, including medium and large companies, would be allowed to expense investments in fixed assets immediately.
- The presumed income tax regimes that apply to the agriculture, transport, mining and real estate sectors would be repealed and replaced with a new optional presumed income regime for small companies in the agriculture, transport and mining industries.
- Taxes would be introduced on emissions from stationary sources and on light vehicles considered a source of pollution.

- Excise taxes on alcoholic beverages and certain non-alcoholic beverages would be increased.
- The tax authorities' personnel and technical resources would be increased.

## Comments

The governing coalition holds a sufficient majority in congress to push the reform through, and it hopes to be able to enact the reform within the next four months. If enacted in its current form, the bill would adversely affect certain Chilean investment structures, in particular, the use of leveraged acquisitions.

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