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# Canadian tax alert

## Chilean tax ruling may affect foreign institutional investors

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On July 27, 2016, the Chilean Superintendence of Securities and Insurance issued General Ruling No. 410 of 2016. The regulation, which is effective as of the date of issuance, clarifies the definition of “institutional investor” for purposes of the rules for regulated investment funds. In essence, the ruling expands the definition of who can be an institutional investor to include qualifying foreign investors. Prior to this ruling, the definition was interpreted to apply mainly to Chilean entities.

This Tax Alert explores the opportunities and issues presented for qualifying foreign investors, foreign funds and collective investment vehicles seeking to obtain favourable tax treatment by utilizing a Chilean regulated investment fund to invest in Chile or perhaps to create a platform for investing in South American or other foreign markets. It should be noted that the application of the tax rules based on this new regime still is under review and it is possible that further guidance will be issued. Thus, the comments below are based on our understanding of how the Chilean tax rules likely will apply.

The Chilean tax system grants beneficial treatment to regulated investment funds:

- Such funds are not subject to corporate income tax;
- Profit distributions made by regulated investment funds to foreign unitholders are subject to a 10% single tax (instead of up to 35% for other investment vehicles). Gains on the disposal of the fund units also are subject to the reduced 10% rate; and
- Distributions of income from non-Chilean sources by regulated investment funds may be exempt from tax, provided the regulated investment fund invests at least 80% of its assets abroad or in derivatives that do not have underlying assets in Chile. In addition, gains on the disposal of units in such funds may be exempt from taxation in Chile if certain requirements are satisfied.

The purchaser of the fund units or the broker or securities dealer acting on behalf of the non-resident investor must apply interim withholding of 5% on the price paid or withhold the final tax rate of 10% on the actual gain.

The regulation provides a tax advantage for investors in foreign markets through a regulated investment fund in Chile, such as a non-Chilean insurance company that meets the definition of an institutional investor that sets up a Chilean regulated investment fund. If the fund invests at least 80% of the value of its total assets in

markets other than Chile, distributions of foreign source income obtained by these funds will be exempt. This includes income from the disposal of foreign assets. Also, gains derived by non-residents from the disposal of units in qualifying regulated investment funds that invest at least 80% of the value of the fund's total assets abroad will be exempt.

The 80% requirement must be met for at least 330 days during the calendar year, and total assets will be calculated as the accounting value of the assets determined on a daily basis in accordance with accounting rules established by the Superintendencia. As well, the 80% requirement must be expressly included in the investment policy which must establish that all Chilean source income must be distributed each year (subject to 10% withholding). If the fund meets these requirements in the year of the disposal and in the two preceding years, the gain on disposal of fund units should be exempt.

One consideration is whether a regulated investment fund could be established in Chile as a vehicle to invest into other countries in South America to obtain favorable treaty benefits, such as partial relief from non-resident capital gains taxes. Many tax treaties entered between Chile and other countries in South America provide partial relief for non-resident capital gains tax if the ownership interest is less than 20%. However, the Chilean revenue authority has ruled that investment funds set up in Chile should generally not be considered as tax residents in Chile for the application of tax treaties. Thus, further analysis would be required on a case by case basis to determine whether a structure can be put in place to mitigate non-resident capital gains taxation in South American countries that impose such tax on the disposal of shares.

To qualify as a regulated investment fund, the fund must be administered by a regulated fund administrator and have a minimum of 50 unitholders. However, the minimum unitholder requirement is waived if an institutional investor participates in the fund. Thus, it seems possible for one institutional investor, such as a non-Chilean based bank or insurance company, to establish a regulated investment fund in Chile through which to make investments in Chile and/or other South American countries. If so, there could be tax benefits to the institutional investor, especially given that the withholding tax rate on distributions would be 10% instead of, for example, 35%.

The following qualify as foreign institutional investors:

- Foreign entities that are subject to the regulations applicable to banks, insurance and reinsurance companies in their country of origin; and
- Foreign funds or other collective investment vehicles that have at least one of the following features:
  - The fund administrator or entity in charge of the investment decisions is subject, in its country of origin, to the supervision of an authority similar to the Chilean Superintendencia of Securities and Insurance; or
  - The fund or investment vehicle itself is subject to the supervision of an authority similar to the Chilean Superintendencia of Securities and Insurance.

More information is still needed regarding how the Superintendencia of Securities and Insurance will interpret the requirement of supervision of an authority **similar** to the Chilean Superintendencia, and what evidence would be necessary. The law relating

to funds and fund administrators expressly refers to the following Superintendence rights and requirements:

- Examine without restriction the records, portfolio and documents of the fund management company and require all information that will allow the authority to assess the status and solvency of the fund management company, and
- Impose the measures necessary to correct deficiencies it may detect.

### **Application to U.S. funds and fund managers**

In the United States, Regulated Investment Companies (RICs) are subject to significant regulation by the Securities and Exchange Commission (SEC) under the Investment Company Act of 1940 ('40 Act). Section 31(b) of the '40 Act provides the SEC with the ability to examine without restriction the books, records and other activities of a RIC or its adviser. It seems likely that this would satisfy the requirement of supervision by an authority with similar attributes to those of the Chilean Superintendence.

Prior to the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act) in 2010, hedge funds, private equity funds and venture capital funds were exempt from registering with the SEC, if they (i) had fewer than fifteen clients during the preceding twelve months, (ii) did not hold themselves out generally to the public as investment advisers, and (iii) were not advisers to any registered investment company under the '40 Act. Advisers taking advantage of this private adviser exemption were still required to comply with the antifraud provisions of the Investment Advisers Act of 1940 (the Advisers Act), but were not required to file registration forms, did not have to maintain business records in accordance with books and records rules, did not have to adopt or implement compliance programs or codes of ethics, and were not subject to SEC oversight.

Many hedge funds, private equity funds and venture capital funds and their advisers took advantage of this exemption and did not register with the SEC, until 2011, when the Dodd-Frank Act amended certain provisions of the Advisers Act. Most relevant of these amendments for this purpose was the repeal of the private adviser exception, with the exclusion of other advisers of private funds with assets under management in the United States of less than US\$150 million, as well as venture capital funds. A private fund with between US\$25 and US\$100 million in assets under management is still required to register as an investment adviser in the state in which it maintains its principal office and place of business, thus shifting the primary responsibility for its regulatory oversight to the state.

Those advisers that are now required to register with the SEC would appear to satisfy the requirement of supervision by an authority with similar attributes to those of the Chilean Superintendence. For those that are required to register with the state in which they maintain their principal office and place of business, it is less clear. An analysis will be necessary with respect to the rules and requirements of each state's authority to regulate such advisers. Those advisers that have not registered with either the SEC or a state are unlikely to have satisfied the requirement of supervision by an authority with similar attributes to those of the Chilean Superintendence.

### **Application to Canadian funds and fund managers**

There are principally two methods by which units/shares of investment funds may be distributed to the public in compliance with securities laws in Canada. First, the disclosure document used to offer the fund to the public may be a prospectus. A prospectus has minimum standards of disclosure and must be reviewed and cleared

for use by the securities commission of each province in which the securities are sold, before the document can be used for that purpose. A similar disclosure requirement would be needed for any exchange traded funds and closed end funds that trade on an exchange. There is no minimum dollar investment amount for funds sold through a prospectus. Most such funds (other than ETFs and closed end funds) are subject to National Instrument 81-102, which is a fairly comprehensive collection of regulatory and compliance burdens imposed on the manager and the fund (including matters such as sales practices, self-dealing and others). It seems likely that a prospectus-based fund having the nature and extent of regulatory oversight that exists in Canada would be considered to be under the supervision of a similar authority to that in Chile. A private placement offering memorandum (OM), is the second method that may be used as the disclosure document to sell units/shares of a fund to the public. An OM is not generally reviewed and blessed by a securities commission. However, an OM can only be used to distribute securities to “accredited investors”. In some provinces, that means that an investor must invest a minimum amount in the fund (e.g., C\$100,000 to C\$150,000). In other provinces, a person is an accredited investor if he or she has a minimum amount of annual income and assets (excluding one’s home).

“Alternatives”, such as hedge funds and private equity funds, are typically distributed to the public through an OM rather than through a prospectus. The funds themselves may not be subject to sufficient regulatory oversight to be comparable to funds subject to supervision in Chile. For such funds to qualify as foreign institutional investors in Chile, it would have to be through the nature and extent of any supervision or oversight of the fund manager in Canada. The compliance burdens imposed on managers of hedge funds and private equity funds include minimum proficiency standards for those individuals making the investment decisions for the funds. The government can also undertake compliance audits. Some analysis would be required to determine whether the regulatory oversight is comparable to that in Chile.

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