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ONE REFORM . . . AND ANOTHER

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OVERVIEW – PART ONE

ØSeptember 2012 Piñera's Tax Reform

A technical fix … From a technical government

- Business Profits tax ("FCT") of 20% never went back to 17%
- Closing the loop on indirect transfers of Chilean sited assets
- Tax amortization of goodwill gets codified
- Capital Gains – Corporations v. Companies (elimination of arbitrage) and the problem of interest deductibility in corporate acquisitions
- Chilean Transfer Pricing rules gets OECD'd
- Concept of attribution re PEs and Branches + Non-Realization Taxation of Gains
- Standard software gets a tax boost

PIÑERA'S TAX REFORM "AIMING FOR A TECHNICAL FIX"

BUSINESS PROFITS TAX - NEVER WENT BACK TO 17%

Ø Until 2010 Business Profits Tax ("FCT") applied at a rate of 17%,

- Post Earthquake Law 20,455 in 2010 increases the Business Profit Tax for two years:

> Income received or accrued on 2011: FCT rate of 20%

> Income received or accrued on 2012: FCT rate of 18,5%

Income received or accrued from 2013 onwards should have been 17%

Ø Law 20,630 of 2012 (the "2012 Reform") kept the FCT rate at 20%:

> Ordinary income accrued on all year 2012 retroactively taxed at a 20% FCT rate

> Capital Gains taxable only with FCT, obtained on:

- From January to August 2012: 18,5%
- From September to December 2012: 20%

See Chilean IRS General Ruling 48 of 2012 .

Closing the loop on indirect transfers of Chilean sited assets

- Ø Traditionally the transfer of foreign entities with Chilean underlying assets was not taxable in Chile (foreign source income obtained by a non-resident taxpayer).
- Ø On 2002, as a response to the "Exxon/Disputada" case, Law 19,840 amended the Chilean Income Tax Law ("ITL"), taxing the gain indirect transfer of Chilean underlying assets generally at a 35% rate provided:
  - The asset being sold were shares or interest participation in a foreign entity which owned a Chilean entity;
  - The acquirer was incorporated, resident or domiciled in Chile; and
  - The underlying Chilean asset represented more than 10% of the respective equity of profit.

- Undesired effect: A foreign acquirer was preferable to avoid taxation in Chile.

- Ø Piñera's 2012 Reform eliminated the requirement of the "Chilean" acquirer and expanded the indirect transfer subject to a 35% tax, including PEs and Branches, as well as other assets sited in Chile, when:
  - Chilean assets represent 20% of the foreign entity and at least 10% is sold;
  - Chilean assets represent more than USD 190 MM and at least 10% is sold;
  - When the foreign entity is domiciled in a tax haven jurisdiction, unless non-Chilean and non tax haven beneficial owners are identified.

- Not clear if these indirect transfer provisions apply in the context of a Double Tax Treaty.

Tax amortization of goodwill gets codified

Ø Until 2012, Chilean Tax Law did not expressly regulated this matter.

- However, since the 90's a consistent string of revenue rulings allowed taxpayers to amortize for tax purposes the positive difference between the price or value of acquisition of a legal entity and its accounting tax value ("Goodwill") in the context of a purchase followed by a merger or liquidation. "Badwill" was not so clearly regulated (but was feared by practitioners).

Ø Pinera's Tax Reform regulated this matter, approving in general terms the Chilean IRS rules:

- Goodwill (Article 31 (9) of the ITL): The positive difference is distributed among the non-monetary assets received on the occasion of the respective merger, until reaching market value (step-up-in-value until FMV is reached). Any remaining difference may be amortized for tax purposes in 10 years.
- Badwill (Article 15 of the ITL): The negative difference is distributed among the non-monetary assets received with occasion of such merger, until reaching market value (step-down). Any remaining difference is treated as deferred revenue in equal instalments within 10 years.

Capital Gains – Corporations v. Companies

- Ø Until 2012, capital gains obtained in the transfer of shares of “stock corporations” v/s interest rights of “companies”, allowing in many cases to “choose” the more attractive tax system by way of a tax-free conversion.
- In some cases, the capital gain obtained in the transfer of interest rights was defined as the excess over the tax book value (including retained earnings), while in the share context, tax cost applied. This did not make sense from a tax policy perspective.
- Ø The 2012 Tax Reform virtually eliminated the dual capital gains tax rules and kept the rules formerly applicable only to shares of corporations, applying to both the potential FCT as a sole tax (20% sole tax) or characterizing the gain as ordinary income

- Ø <u>Problem</u>: the Chilean IRS traditionally had characterized interest paid for loans used to acquire shares of corporations as non-deductible expenses based on the capital gains treatment of shares. This is the reason behind the “<u>dual corporate acquisition structure</u>” leveraged at the upper level, present in many Chilean acquisitions.

- <u>Undesired effect of this change:</u> The deductibility of interest associated to share/ interest purchases is jeopardized. The issue was not resolved in the law, forcing the IRS to try to clean up this mess (unsuccessfully).

Transfer Pricing Rules get OECD'd

- Until 1997, the ITL did not have transfer pricing rules, but only broad powers held by the Chilean IRS to challenge non-market-values under Article 64 of the Tax Code and similar old fashioned (effective but rarely used) rules.
- On 1998, Law 19,506 introduced transfer pricing rules to Article 38, but rules were considered to be deficient and the Chilean IRS did used them in just a few cases.
- The 2012 Tax Reform amended the cited Article 38 and added a new Article 41 E to the ITL, introducing transfer pricing rules in line with the OECD principles.
  - Application of the "best method" rule, in accordance to the OECD Principles and Guidelines.
  - Relevant Taxpayers must submit a special Transfer Pricing Annual Sworn Statement, as the Chilean IRS is avid for information.
  - Advanced Pricing Agreements are introduced (see Resolution 68 of 2013).

Concept of attribution re PEs and Branches + Non-Realization Taxation of Gains

- Until 2012, Chilean income of Permanent Establishments and Branches of foreign entities was determined using its "real results" obtained "in the country".
- This gave rise to potential problems like interest obtained by a Branch on a cross border loan and similar income "attributable" to the PE or Branch.
- The 2012 Tax Reform replaces the "Chilean source" concept with the OECD's "attribution" principle, pursuant to which all income attributable to the Chilean PE or Branch is taxed in Chile.

- In addition, the "Assignment of assets" made by a foreign entity to a PE or Branch is regulated, allowing the Chilean IRS to appraise it, under the provisions of Article 64 of the Chilean Tax Code, even when they are not proper "transfers of property".
  - The Chilean IRS appraisal will not apply if the "assignment":

  (i) Corresponds to shares or interest participation in Chilean corporations/companies;

  (ii) Obeys to a legitimate business reason;

  (iii) Does not originate an effective cash flow to the parent company; and

  (iv) Is registered in the PE or Branch books at its tax or book value.

Standard software gets a tax boost

- Until 2012, royalties arising from "Standard Software" were taxed at a 15% WHT rate, or 30% if the beneficiary (a) was incorporated, domiciled or resident in a tax haven, or (b) qualified as a related party as per the rules of Article 59 of the ITL

- The 2012 Tax Reform gave Standard Software a tax exemption from WHT.

- Problem 1: Legal definition of "Standard Software is obscure, as it refers to those in which the rights transferred are limited to the ones necessary to allow its use, and not its commercial exploitation, nor its reproduction or amendment with any other end than to enable it to its use.
  - Direct sale or MS Office to end consumer = standard?
  - Sale of MS Office to reseller = not standard?

- Problem 2: During the legislative discussion of the Tax Reform, digital books were considered to be included in the tax exception granted to Standard Software, but the law did not expressly include them.

BACHELET'S
2014 TAX REFORM

"TO INFINITY . . .
. . . AND BEYOND !!!"

OVERVIEW – PART TWO

Ø 2014 Bachelet Tax Reform currently in Congress

“To infinity and beyond”

- Business Profits Tax of 20% increases to 35% (or was it 25%?)
- The concept of “attributable income” (cashless taxation) + elimination of the much loved and source of all evil called “FUT”
- New capital gains regime (no more reduced capital gains tax)
- Real Estate Gets a “double whack” – some capital gains exemptions get eliminated and VAT is applied to developers.
- Interest associated to purchases of companies no longer deductible
- The CFC Regime comes to Chile
- A new twist on “debt to equity ratios”
- “Green” taxes + “Health” taxes
- The fall of the great and mighty DL 600
- GAAR to curve tax avoidance and abuse + a hit on “promoters” and advisors

Business Profits Tax of 20% increases to 35% (or was it 25%?)

- Currently, Business Profits Tax ("FCT") applies at a 20%.
- On the Tax Reform Bill presented by Ms. Bachelet on April 1st, 2014, (the "Bill"), currently being discussed by Congress, the FCT rate should increase to 25% in the following manner:
- Income received or accrued on 2014: FCT rate of 21%
- Income received or accrued on 2015: FCT rate of 22,5%
- Income received or accrued on 2016: FCT rate of 24%
- Income received or accrued on 2017: FCT rate of 25%

- In addition, starting tax year 2018 (calendar 2017), the "FUT" is eliminated so:
  - Non resident owners of Chilean businesses will be subject to the 35% Dividend Withholding Tax on the tax profits accrued by such Chilean businesses irrespective of whether a dividend distribution is made; and
  - Similarly, Chilean resident or domiciled individuals who own Chilean businesses will be subject to Surtax (0% to 40%) on such tax profits irrespective of whether such profits have been distributed as dividends.

- In addition, businesses whose owners are either legal entities or non-resident persons or entities, (ie. most of the mid-sized and large entities) will be subject to an additional 10% withholding, which may be deducted from dividends.

The concept of "attributable income" + elimination of the FUT

- Starting tax year 2018, the Tax Reform Project proposes to eliminate the "FUT" (Taxable Income Fund), changing the current system based on "**distribution**" of income for a new system of "**attribution**" of income.
- The remaining FUT at December 31, 2016 will be maintained, only being taxable the amounts distributed to the final taxpayers (using the traditional FIFO regime)
- The income attributable to the Surtax/WHT taxpayers shall be composed of:

(i) The entity's positive outcome (income), resulting in the determination of the FCT; and

(ii) Income or amounts attributable to the entity acting as shareholder, owner, partner or community member of another entity, whether or not forced to determine its effective income under full accountant.

As Surtax is reduced to 35%, **in practice dividend taxation is eliminated**, as both the 25% FCT and 10% special withholding represent a credit.

- The income attribution shall be made as follows:

(i) As the owners have previously agreed through a public deed; or

(ii) In the proportion of their participation in the paid capital of the business entity..

- The Chilean IRS will have powers to reasonably challenge the form of attribution, being able to attribute the income like it has being made in fair market conditions (**anti income shifting rule**).

The only piece of good news: Starting tax year 2018, distributions are imputed first to the newly created "attributable income" and only excess distributions are imputed to the historic FUT, avoiding double taxation of distributions.

No more reduced capital gains tax regime for shares and interest participations + Interest deductibility limitation

- Currently, if your have a holding period of more than 1 year, are not an habitual trader and the transferee is not "related" to you, a capital gains tax of 20% applies, instead of the normal 35% or 40% applicable to ordinary income.
- The Bill replaces this regime for the following:
- If the transferor has full accounting records (most corporations, companies and unincorporated businesses), the gain is characterized as ordinary income, subject to a total tax burden of 35% (in the case of non-residents) and up to 40% in the case of resident individuals.
- If the transferor is a non-resident individual or entity, a tax of 35% is applied;
- If the transferor is a resident individual, and has a holding period of more than one year, the capital gain is divided by the number of years of such holding period, and is allocated to such periods in order to determine its effective Surtax rate (Surtax applies with brackets ranging from 0% to 40%); and
- If the transferor has a holding period of less than a year, the capital gain is characterized as ordinary income (FCT + Surtax/WHT).

Interest Deductibility Limitation

- Interest and other financial expenses arising from loans destined to acquire securities will not be considered to be deductible expenses, but will be capitalized (representing part of the cost of the asset).
- EFFECT: Simple share acquisitions? No. Cumbersome asset acquisitions? Welcome!!

Real Estate Gets a “double whack”

Ø The Tax Reform Bill proposes to eliminate in general terms the characterization as non-taxable income of the profit made in the transfer of real estate located in Chile (see Articles17 (8) (b) and 18 of the ITL), in the following manner:

- General rule: gain qualifies as ordinary income
- Exception 1:
  - If the transferor is a resident individual, and has a holding period of more than one year, the gain is allocated to those years for Surtax purposes; and
  - > Improvements made to the property count as additional cost if they were declared in time to the Chilean IRS for purposes of the Property Tax valuation (which is rarely done).
- Exception 2: Gain is characterized as non-taxable the profit made in the transfer of the only real estate property owned by the taxpayer, which qualifies as his home or his family’s home, up to UF 8,000 (aprox. USD 350,000).

Ø **VAT reaches Real Estate Property** (and not just the construction activity)

Ø The Bill aims to include all transfers of real estate made by habitual sellers in the VAT regime.

- Major Effects: (a) the end of the Construction Company + Real Estate Developer Tax planning structure, and (b) an extra cost of 19% over the developer’s profit in respect of housing, resulting in higher housing prices.

A CFC Regime comes to Chile

- Ø Starting on calendar 2015 (tax year 2016), the Bill contemplates a new CFC Regime applicable only to passive income.
- Ø Direct or indirect control is defined as 50% or more of the equity, profits, voting rights, or ability to appoint management.
- Ø Unless proven otherwise, it is presumed that:
  - § Entities in which the Chilean resident has a purchase option are controlled:
  - § Entities located in low tax jurisdictions are controlled;
  - § Entities located in low tax jurisdictions generate only passive income:
  - § Entities located in low tax jurisdictions generate income equivalent to the interest rate applicable in such jurisdiction to the amount invested in them by the relevant Chilean parties.

- Ø Low Tax Jurisdictions are redefined as those: (a) with effective taxation equivalent to less than 50% of 35%: (b) with no TIE with Chile; (c) whose tax authorities do not have transfer pricing powers recommended by the OECD or UN; (d) which have limitations on tax information gathering or exchange; (e) defined as tax havens by the OECD or UN; and (f) those with income taxation at source.

- CFC provisions do not apply if such passive income does not exceed 2,400 UF (approx. USD 100,000) per year.

A new twist on "Debt to Equity Ratio" or "Excess of Indebtedness Regime"

Ø The Bill, by introducing a new Article 41 F in the ITL, changes the so called "Excess of Indebtedness Regime" formerly associated to excess of related party indebtedness qualifying for the reduced 4% WHT on interest. The "excessive" interest will be taxed at a 35% rate, a tax that will be deductible for the debtor/payer.

- Excess of indebtedness is defined as:
  - (i) The indebtedness of with foreign entities, related or not, exceeding 3 times its equity; and
  - (ii) Interest commissions, remuneration for financial services, financial expenses or any other contractual surcharge (including reimbursements of expenses) paid to related parties if they exceed 50% of the net taxable income of the debtor.
- To calculate the 3:1 ratio, only (a) interest subject to the 4% WHT; (b) local indebtedness; and (c) indebtedness acquired by foreign Branches or PEs.
- The current concept of related party, tax haven, etc. remains more or less similar
- Exclusions from this regime:
  - Project Finance
  - Financial institutions.

Health Taxes Green Taxes and Stamp Tax

- The Bill aims to introduce:
  - An increased tax on soft drinks deemed unhealthy (there are technical specifications), which in Congress is opening the discussions on taxing junk food
  - An increased tax on alcoholic beverages (much resisted in Congress due to the Pisco lobby)
  - A tax on vehicles running on diesel fuel (deemed less green than gasoline)
  - A tax on fixed base emissions (which has been associated mostly to power generation plants)

  - Stamp Tax rate would be duplicated, reaching a maximum of 0.8% (as technically is being considered as an equivalent to VAT on financial services).

The rise and fall of DL 600 - The Foreign Investment Statute

- DL 600 of 1974 has been a cornerstone of foreign investment for 40 years, and its earlier version was also very important.
- Benefits
  - Investment Protection and Non discrimination
  - Right to repatriate capital and profits
  - Guaranteed access to foreign exchange market
  - The much touted, but not that important Tax Invariability
- Arguments used for eliminating it:
  - Chile has evidenced its standing as a reliable investment destination and is part of the OECD. No extra guarantees are required.
  - There are multiple investment protection treaties which overlap the DL 600 guarantees.
  - DL 600 is a unilateral concession in matters normally covered by investment protection treaties.
- Problems:
  - Chile has been a stable destination in an unstable region
  - The Bachelet government has announced major economic changes and the desire to change the Constitution.

GAAR and Tax Promoters & Advisors

- Chile has never had a proper GAAR
- Strong constitutional language has ben construed as forcing taxes to be defined exclusively by the law.
- Tax abuse and avoidance and the difficulty on closing loopholes are perceived as very problematic, especially in the context of a government agenda aiming to minimize inequality, and to obtain greater fairness.
- In this respect the Bill, following in some aspects the model introduced in Spain:
  - Amends the law clearly stating that tax laws cannot be avoided though the abuse of legal configuration, understood as tax minimization caused by artificial, improper, those whose only relevant effects are tax effects and simulation.
  - Gives the Chilean IRS the power to declare such abuse, simulation, etc (declaration which may be contested by litigation)
- In case such abuse, simulation, etc. was asserted, the original Bill applied a penalty equivalent to 100% of the taxes avoided to the accountant, advisor, attorney, auditor and their respective firms and directors, generating multiple penalties for the same action.

THANK YOU !!

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