The new PE/VC fund regime in Chile: One law to rule them all

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Francisco Ugarte *and* ***Luciano Aguilera*** *of* ***Carey*** *in Santiago look at the rules surrounding private equity and venture capital*

For the past decade Chile has certainly excelled as one of the most investor friendly countries in the region, being placed for the eighth consecutive year at the top of the ranking of LAVCA's 2013 Scorecard for Private Equity and Venture Capital Environment in Latin America.

In spite of this promising environment, Chile lacked a proper asset management regulation, existing diverse laws and regulations that governed substantially similar financial services, making local and foreign investor incur in unnecessary costs and expenses.

In an attempt to enhance the local private equity and venture capital environment, the previous administration enacted Law No. 20,712 (also known as the "Single Funds Act") and its respective regulation, which came into force on May 1 2014, consolidating the regulation of private equity and venture capital investment funds in a single bill. As a result, the old regulations that governed mutual funds, investment funds, foreign capital investment funds, and real estate funds were repealed.

Key features to be considered by foreign investors

The Single Fund Act now only distinguishes between two types of funds that are subject to the supervision of the Securities and Insurance Commission (SVS): (i) mutual funds, which are those that allow the total redemption of shares, which redemption must be paid within ten days or less, and (ii) investment funds, which are defined as those that are not mutual funds, and thus, generally do not permit the redemption of shares and if otherwise permitted, it has to pay their participants the redeemed shares in a term equal or higher than 180 days. As a separate category, the Single Funds Act governs private investment funds (PIF), which are characterised as those that are not subject to the SVS's supervision and have less than 50 participants.

This new law also comes to establish for the first time activities and investments that are banned for funds, and sets forth the duty of care of the managing companies of the funds subject to the SVS's supervision. In this regard, although the managing companies may not delegate their managing function, they may well grant powers of attorney and enter into service agreements with third parties for the execution/conduct of certain business acts or related activities of the respective fund.

Additionally, in order to ensure that PIFs will act as collective investment vehicles, the Single Funds Act requires that within a year of the incorporation of a PIF, it must have at least four unrelated participants and none of them may own less than 10% of the fund, unless an institutional investor owns at least 50% of the fund. A breach to this rule would seriously affect the favourable tax regime of the respective PIF, since it would be considered as stock company for tax purposes.

From a tax perspective, under the Single Funds Act investment funds and PIFs have maintained their condition as non-taxpaying entities, and thus, are still exempted from payment of corporate income tax on profits earned or accrued (corporate income tax has a 20% tax rate on the annual accrued net taxable income), but remain subject to a withholding tax of 35%. One of the most noticeable changes made by the Single Funds Act is that remittances, distributions, payments, and account crediting made by investment funds to foreign investors with no residence in Chile will be subject to a preferential 10% sole tax rate. However, there are certain situations in which foreign investors are exempted from this 10% tax rate (e.g., if the funds are invested substantially in foreign assets). This new law does not make this preferential tax rate available to PIFs.

The FCIF situation

The Single Funds Act has had a substantial impact on the existing foreign capital investment funds (FCIF), since law 18,657 (FCIF Law) has been completely repealed. Only one transitory rule of the Single Funds Act has covered the FCIF situation, allowing us to conclude that as of May 1 2014:

(i) foreign investors may no longer incorporate FCIFs in Chile, thus, they will only be entitled to incorporate the vehicles available under the Single Funds Act;

(ii) the existing FCIFs may continue their operations in Chile maintaining the tax stability benefit contemplated by the former FCIF Law for already made or previously authorised investments in accordance with the foreign investment contract ruled by Chilean Decree Law 600;

(iii) the tax rules established by the FCIF Law shall remain effective for the existing FCIFs, to its existing investments and subsequent operations; and

(iv) the existing FCIFs may not transform in or merge into any of the funds governed by the Single Funds Act.

New trends and risks

Even before the Single Funds Act became effective, the new administration that took office in March 2014, submitted to Congress an extensive tax reform arguing the need to confront –in the administration's view- Chile's income distribution inequality. This bill contemplates important amendments that include changes to the corporate tax rate, the taxation of Chilean investments abroad (controlled-foreign-corporation rules), the source-rule of bonds, the stamp tax rate, and the elimination of the taxable profits fund or FUT, among others. This tax reform also plans to change the Single Funds Act by making investment funds and PIFs withhold 10% and 35% of their taxable income, respectively, meaning that PIFs would be eventually subject to the same tax regimes as stock companies.

Going forward, although the outcome of this tax reform and how will Chile adapt to its changes in the long term is still unclear, it has set off the alarm bells for businessmen, who fear the negative effects that this reform may bring to investments and economic growth in Chile.

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