

CHILEAN TAX REFORM DETAILS

Chile's education tax

Latin Lawyer

Not long into her second term, Chilean President Michelle Bachelet has announced a new tax reform aimed at funding an overhaul of the country's education system – but not without setting off alarm bells in the corporate sector. Carey partners Jaime Carey, Jessica Power and Alex Fischer lay out the all-important details

On 1 April 2014, only 20 days into her second term as the President of Chile, Ms Bachelet submitted to Congress a tax reform bill. The stated goals of the reform are to collect an additional US\$8.2 billion of revenue to invest in education and to improve income distribution among Chileans.

If enacted, the tax reform would be the most substantive tax law change in the past 30 years in Chile. Overall, and sacrificing significant precision for the sake of clarity, the reform effectively moves the current 20 per cent corporate income tax to 35 per cent, and exempts dividend payments. It further creates a corporate tax rebate system for individual investors in a tax bracket lower than 35 per cent, such that the corporate tax is "attributed" to each investor and levelled to his or her marginal income tax rate. This is done through a collection of new record-keeping and filing obligations that will surely create lots of headaches and errors for the tax administration and taxpayers. The scope and depth of the reform ensure a steep learning curve.

This novel and unique "attribution" system is being highly criticised by the business and professional community for ridding the tax system of its savings and investment structural incentives. Currently, a relatively low tax burden (20 per cent) is assessed on corporate profits, and a supplement of up to 20 per cent (depending on the investor's marginal tax rate) penalises dividend distributions.

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A description of the main effects of the tax reform follows.

Corporate income tax hike to 35 per cent

The corporate income tax rate will effectively increase to 35 per cent. This results from: (i) a direct increase of the corporate tax rate to 25 per cent over four years, starting in 2014 (21 per cent, 22.5 per cent, 24 per cent and 25 per cent); and (ii) an indirect increase in the form of a 10 per cent mandatory withholding of taxable income on account of shareholder taxes. These new rules will enter into effect in commercial year 2017.

As a consequence of the hike to 35 per cent of the corporate income tax, dividends paid to non-resident shareholders will be de facto exempt from withholding tax.

Personal income tax reduction

The proposed bill reduces the top marginal rate of the personal income tax (and payroll tax) for Chilean-resident individuals from 40 per cent to 35 per cent. The payroll tax rate reduction will be effective in the month following the publication of the law, while the reduction of the personal income tax will take effect in 2017.

The reform de facto exempts received dividends from the personal income tax, yet preserves a tax credit towards the personal income tax in the amount of the taxpayer's indirect share of corporate taxes borne by its shareholdings. This tax credit is better understood as a rebate to shareholders for corporate taxes paid by the entities in which they invest, in excess of their marginal personal income tax rate. It is an attempt to make the corporate tax burden progressive at the individual shareholder level.

The tax rate reduction of the personal income tax is counterbalanced by a major expansion of the tax basis: (i) the tax exemption on the disposition of real property is severely narrowed; (ii) the reduced rate on capital gains is eliminated; (iii) presumptive income regimes are abrogated or limited; and (iv) new income attribution rules potentially allocate a greater share of income to higher-earning taxpayers.

Capital gains tax hike

Capital gains realised by resident individuals or non-resident taxpayers on the disposition of shares in Chilean companies may presently qualify for a sole capital gains tax of 20 per cent. The

proposed bill eliminates this reduced rate, and beginning in 2017, levies the capital gain with personal income taxes. In the case of resident individuals, the personal income tax rate would be equal to the taxpayer's average marginal rate over the investment holding period, and in the case of non-residents, a 35 per cent withholding tax.

Thin capitalisation rule

The tax reform severely restricts the ability to fund investments in Chile with shareholder-loan structures that currently qualify for a reduced 4 per cent (versus 35 per cent) withholding tax on interest payments:

The 3:1 debt-to-equity limit would be tested on the aggregate of related-party and third-party debt. Currently, only related-party debt is counted.

The 3:1 debt-to-equity limit would be tested annually, in lieu of the one-time test that is currently applied upon disbursement of each loan.

A second prong would be added to the thin capitalisation test that would disqualify interest paid in excess of 50 per cent of taxable income.

The 35 per cent surtax is levied, in addition to interest, on all charges and fees linked to excessive indebtedness.

Stamp tax revival

The maximum stamp tax rate, which had been gradually reduced on policy grounds since 2009, would increase from 0.4 per cent to 0.8 per cent, beginning in 2016. Stamp tax levies the principal amount of debt instruments or documents evidencing indebtedness for borrowed money.

Tax haven definition: lost paradise

Rather than a closed list of jurisdictions, the bill defines a tax haven as a jurisdiction that: (i) taxes foreign source income with less than 17.5 per cent; (ii) has not entered into an information exchange agreement with Chile; (iii) does not have relevant transfer pricing rules; (iv) is identified as a preferential tax regime by the OECD; or (v) only taxes local source income. These rules would be effective from

2017.

CFC rules

Passive income of a foreign entity would be recognised on accrual by the Chilean-resident controlling shareholder. Passive income includes dividends, interest (except banking or financing entities), royalties, certain capital gains, income for the lease of real estate (except to entities to which the real estate lease is its main business) and income generated in specific operations with Chilean related parties. It would be deemed that a foreign entity is controlled by a shareholder with a 50 per cent or more interest in the equity, results or voting rights. Additionally, entities located in a tax haven jurisdiction would be deemed controlled, unless it could be proved otherwise.

GAAR

The bill proposes an overreaching general anti-avoidance rule (GAAR). The tax administration would have the ability to re-characterise any transaction whose legal form or sequence is deemed abusive, artificial or inconsistent with its substance. Attorneys, accountants and other tax advisers may be penalised for participating in “elusive” tax planning. The penalty may be up to 100 per cent of the “eluded” taxes, capped at approximately US\$100,000.

Ms Bachelet’s coalition has a majority in both chambers of Congress, and the reform is expected to be approved in a form which is substantially similar to the version submitted by her. Yet, in addition to the centre-right opposition, some governing coalition senators have begun to voice concern over the reform. Refreshingly, openness has been shown by the Ministry of Finance to engage in a substantive discussion.

The target approval date is currently set at September 2014. Most changes would be effective in 2015, yet the more structural changes would be delayed until 2017.